COMMODITY FUTURES TRADING COMMISSION REAUTHORIZATION

HEARINGS

BEFORE THE

SUBCOMMITTEE ON AGRICULTURAL RESEARCH AND GENERAL LEGISLATION

OF THE

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY
UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

ON

S. 2109

TO EXTEND THE COMMODITY EXCHANGE ACT, AND FOR OTHER PURPOSES

FEBRUARY 26, AND MARCH 1, 2, 10, AND 11, 1982

Printed for the use of the
Committee on Agriculture, Nutrition, and Forestry

U.S. GOVERNMENT PRINTING OFFICE
93-759 O WASHINGTON : 1982

S161-16

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

JESSE HELMS, North Carolina, *Chairman*

BOB DOLE, Kansas
S. I. HAYAKAWA, California
RICHARD G. LUGAR, Indiana
THAD COCHRAN, Mississippi
RUDY BOSCHWITZ, Minnesota
ROGER W. JEPSEN, Iowa
PAULA HAWKINS, Florida
MARK ANDREWS, North Dakota

WALTER D. HUDDLESTON, Kentucky
PATRICK J. LEAHY, Vermont
EDWARD ZORINSKY, Nebraska
JOHN MELCHER, Montana
DAVID H. PRYOR, Arkansas
DAVID L. BOREN, Oklahoma
ALAN J. DIXON, Illinois
HOWELL HEFLIN, Alabama

GEORGE S. DUNLOP, *Chief of Staff*
J. ROBERT FRANKS, *General Counsel*
CARL P. ROSE, *Counsel and Staff Director for the Minority*

SUBCOMMITTEE ON AGRICULTURAL RESEARCH AND GENERAL LEGISLATION

RICHARD G. LUGAR, Indiana, *Chairman*

BOB DOLE, Kansas
S. I. HAYAKAWA, California
RUDY BOSCHWITZ, Minnesota
MARK ANDREWS, North Dakota

DAVID L. BOREN, Oklahoma
WALTER D. HUDDLESTON, Kentucky
DAVID H. PRYOR, Arkansas
HOWELL HEFLIN, Alabama

CONTENTS

Page

Lugar, Hon. Richard G., a U.S. Senator from Indiana, opening statement 1, 111, 207, 257

Huddleston, Hon. Walter D., a U.S. Senator from Kentucky 2

Jepsen, Hon. Roger W., a U.S. Senator from Iowa 9

Dole, Hon. Bob, a U.S. Senator from Kansas 12

Boren, Hon. David L., a U.S. Senator from Oklahoma 12

CHRONOLOGICAL LIST OF WITNESSES

Friday, February 26, 1982

Johnson, Hon. Philip McB., Chairman, Commodity Futures Trading Commission, accompanied by Dennis Dutterer, General Counsel; Tom Loughran, Director, Enforcement; John Manley, Director, Trading and Markets; Jim Culver, Director, Economics and Education; and Susan Wagner, Executive Director 3

- Letter dated May 5, 1982, to Senator Lugar in response to questions asked Chairman Johnson during the hearing 42
- Letter dated February 23, 1982, to Senator Helms, from James M. Stone 45
- Letter dated March 25, 1982, to Senator Lugar, from Chairman Johnson, in response to the request of Senator Dole 62
- Letter dated March 19, 1982, to Senator Lugar, from Chairman Johnson, containing answers to questions by Senators Lugar and Helms 66
- Letter dated April 14, 1982, to Senator Lugar, from Chairman Johnson, with answers to additional questions by Senator Lugar, with attached letter dated March 8, 1982, to Hon. Charles A. Bowsher, Comptroller General of the United States 91
- Letter dated March 29, 1982, to Senator Lugar, from Chairman Johnson, in response to questions from Senator Boren 101

Monday, March 1, 1982

Melamed, Leo, president, National Futures Association; accompanied by Patricia Carlile, acting executive director, and John Stassen, general counsel 111

Berendt, Lee H., executive vice chairman, Commodity Exchange, Inc 125

Wilmouth, Robert K., president, Chicago Board of Trade, Chicago, Ill 129

Yeutter, Clayton K., president, Chicago Mercantile Exchange 132

Corn, Bennett J., president, Coffee, Sugar & Cocoa Exchange, Inc 156

Morgan, David H., president, MidAmerica Commodity Exchange 159

Batte, Robert, first vice president, Kansas City Board of Trade, accompanied by Walter N. Vernon, chief executive officer 162

Tuesday, March 2, 1981

Eschwege, Henry, Director, Community and Economic Development Division, General Accounting Office, accompanied by Lowell Dodge, Associate Director; Ralph Lowry, senior GAO evaluator; and James Noel, economist 175

Gillen, Neal P., vice president and general counsel, American Cotton Shippers Association 183

Amstutz, Daniel G., chairman, Commodity Exchange Committee, National Grain and Feed Association, and general partner, Goldman, Sachs & Co., New York, N.Y 188

Page

Proctor, Stuart, assistant director, National Affairs Division, American Farm Bureau Federation ... 191

Barbanel, Jack A., general counsel, Commodities Corp., Princeton, N.J ... 193

Eret, Don, on behalf of the American Agriculture Movement, Inc ... 199

Brooks, William F., president and general counsel, National Grain Trade Council ... 202

WEDNESDAY, MARCH 10, 1982

Lesher, Hon. William G., Assistant Secretary for Economics, U.S. Department of Agriculture ... 207

Stotler, Howard A., immediate past chairman, Futures Industry Association, Inc ... 216

Schroeder, Edmund, chairman, Committee on Commodities Regulation, American Bar Association ... 221

Russo, Thomas A., chairman, Committee on Commodities Regulations, Association of the Bar of the City of New York, and members Howard Schneider, Richard Nathan, and Richard A. Miller ... 224

Conheeney, John J., chairman of Merrill Lynch Commodities, New York, N.Y ... 236

Johnston, David T., senior vice president, E. F. Hutton, New York, N.Y ... 238

Heinold, Harold J., chairman of the board, Heinold Commodities, Inc., Kouts, Ind ... 241

Unger, Michael, director of Massachusetts Securities Division, on behalf of the North American Securities Administrators Association, Inc.; accompanied by Orestes Mihaly, assistant attorney general in charge, New York Bureau of Investor Protection and Securities, and K. Houston Matney, Maryland Securities Commissioner ... 246

THURSDAY, MARCH 11, 1982

Thomte, Theodore, director, National Association of Futures Trading Advisors ... 257

Burr, Clinton, general counsel, Rosenthal & Co., Chicago, Ill ... 262

Carabini, Louis F., president, Monex International, Ltd ... 265

Groberg, James J., chairman of the board, International Precious Metals Corp ... 268

Simon, David F., general counsel, First National Monetary Corp ... 271

Clark, Glenn W., Glenn Willett Clark Associates ... 281

Fishman, Gerald L., representing Dowdex Corp ... 283

Ek, Carl W., legislative assistant, National Farmers Union ... 284

APPENDIX

Boren, Hon. David, a U.S. Senator from Oklahoma, statement ... 293

Johnson, Philip McB., Chairman, Commodity Futures Trading Commission, supplemental statement ... 294

Melamed, Leo, president, National Futures Association, statement, with attachment ... 322

Berendt, Lee H., executive vice chairman, Commodity Exchange, Inc., New York, N.Y., statement with attached letter dated April 29, 1982, to Senator Helms ... 335

Wilmouth, Robert K., president and chief executive officer, Board of Trade of the City of Chicago, statement ... 376

  Letter from Mr. Wilmouth dated May 11, 1982, to Senator Helms in response to inquiries at the hearing ... 387

Yeutter, Dr. Clayton K., president, Chicago Mercantile Exchange, statement ... 395

Corn, Bennett J., president, Coffee, Sugar & Cocoa Exchange, Inc., statement ... 411

Morgan, David H., president, MidAmerica Commodity Exchange, statement ... 419

Gibson, David W., second vice president, and Walter Vernon, executive vice president and chief executive officer, the Board of Trade of Kansas City, Mo., Inc., statement ... 441

Eschwege, Henry, Director, Community and Economic Development Division, General Accounting Office, proposed amendments to the Commodity Exchange Act ... 446

Gillen, Neal P., vice president and general counsel, American Cotton Shippers Association, comments of the American Cotton Shippers Association ... 449

Gray, Roger W., Food Research Institute, Stanford University, Analysis of the Chicago Board of Trade Cotton Futures Contract Proposal ... 469

Amstutz, Daniel G., chairman, Commodity Exchange Committee, National Grain and Feed Association, statement ... 490

Page

Proctor, Stuart E., Jr., assistant director, National Affairs Division, American Farm Bureau Federation, statement ... 495

Barbanel, Jack A., general counsel, Commodities Corp., Princeton, N.J., statement ... 498

Eret, Don, American Agriculture Movement, statement ... 506

Brooks, William F., president and general counsel, National Grain Trade Council, statement ... 508

Lesher, William G., Assistant Secretary for Economics, U.S. Department of Agriculture, statement ... 513

Stotler, Howard A., immediate past president, Futures Industry Association, Inc., statement ... 518

"Commodity Margins—Whose Responsibility," by Mark J. Powers, inserted by Futures Industry Association ... 530

Schroeder, Edmund R., chairman, Committee on Commodities Regulation, American Bar Association, statement with attached exhibits ... 539

Russo, Thomas A., chairman, Committee on Commodities Regulation of the Association of the Bar of the City of New York, statement ... 575

Schneider, Howard, statement re: Commodity pool issues ... 577

Nathan, Richard E., statement re: The standards of conduct imposed upon commodity industry professionals ... 583

Miller, Richard A., statement re: The reparations process ... 587

Conheeney, John J., chairman, Merrill Lynch Commodities Inc., statement ... 592

Heinold, Harold J., testimony of, with attached appendix ... 601

Unger, Michael, director, Massachusetts Securities Division, Orestes J. Mihaly, assistant attorney general in charge, New York Bureau of Investor Protection and Securities, and K. Houston Matney, Maryland Securities Commissioner, joint statement submitted for the North American Securities Administrators Association, Inc ... 611

Thomte, Theodore, director, National Association of Futures Trading Advisors, statement ... 635

Burr, Clinton, general counsel, Rosenthal & Co., Chicago, Ill., statement ... 649

Carabini, Louis E., president, Monex International, Ltd., testimony ... 659

Groberg, James J., chairman of the board, International Precious Metals Corp., statement ... 665

Simon, David F., general counsel, First National Monetary Corp., statement with attachment ... 672

Fishman, Gerald L., Dowdex Corp., statement on behalf of ... 679

Rosenthal, George, chairman, National Affairs Committee, Independent Bakers Association, statement ... 685

Clark, Glenn Willett, Glenn Willett Clark Associates, McLean, Va., statement 690

Ek, Carl W., legislative assistant, National Farmers Union, statement ... 691

Mehle, Roger W., Assistant Secretary, U.S. Department of Treasury, letter dated March 12, 1982, to Senator Helms, expressing the administration's position on reauthorization of the CFTC ... 695

Reprint of S. 2109 ... 696

COMMODITY FUTURES TRADING COMMISSION REAUTHORIZATION

FRIDAY, FEBRUARY 26, 1982

U.S. SENATE,
SUBCOMMITTEE ON AGRICULTURAL RESEARCH
AND GENERAL LEGISLATION OF THE
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, D.C.

The subcommittee met at 9:30 a.m., in room 324, Russell Senate Office Building, Hon. Richard G. Lugar (chairman of the subcommittee) presiding.

Present: Senators Lugar, Dole, Hayakawa, and Boren.

Also present: Senator Jepsen.

STATEMENT OF HON. RICHARD G. LUGAR, A U.S. SENATOR FROM INDIANA

Senator LUGAR. The subcommittee will come to order.

I would like to make a short initial statement and then I will introduce our opening witnesses.

Today the Subcommittee on Agricultural Research and General Legislation begins 5 days of hearings on the reauthorization of the Commodity Futures Trading Commission.[1]

We have witnessed in recent years a remarkable growth in the futures industry. There is every reason to expect that this growth will continue in the coming years as well. The futures industry serves important functions. It provides both a general price-discovery function and a means of hedging against the price risks accompanying commercial activities relating to agricultural and other commodities as well as financial instruments.

As we consider reauthorization legislation for the CFTC, we must be mindful of the growth of the industry it was created to regulate. A healthy and vigorous futures industry depends ultimately upon a strong measure of public confidence in its activities. I believe that everyone, including futures industry representatives, agrees that effective regulation is necessary to protect the public, commercial hedgers, and the industry itself from unscrupulous persons. The industry itself has undertaken significant efforts at self-regulation, including the development of an industrywide self-regulatory organization.

---

[1] See p. 696 for the text of S. 2109 and p. 695 for a report from the Department of the Treasury concerning S. 2109.

At the same time, questions have arisen about the scope and the effectiveness of the CFTC's monitoring and enforcement procedures under current law. The Commission's draft bill proposes a number of changes and clarifications in the CFTC's authority with this in mind. The subcommittee will consider carefully all testimony proposing changes to streamline and improve the functioning of the CFTC.

The subcommittee, too, will consider the question of who should pay for the CFTC's regulatory activities. There are, of course, differing views on this subject, and the subcommittee will consider both the question of who benefits from the regulatory programs of the CFTC and the overall budgetary impact of differing proposals.

This morning we are delighted to receive testimony from Philip Johnson, Chairman of the Commodity Futures Trading Commission. We welcome you this morning, Mr. Johnson.

I would simply add a personal note. The subcommittee, and in particular, the chairman, appreciates your thoughtful briefings on the development of what has been your events throughout the Commission, and in my judgment a year in which the powers have strengthened and, in large part, through your leadership and the community interests that you have had with fellow Commissioners.

My understanding is today that you come to the hearing speaking for all of the members of the Commission, and I know you will clarify at least the voice in which you speak in your statement.

I appreciate your coming and the spirit in which you approach this reauthorization and reform.

STATEMENT OF HON. WALTER D. HUDDLESTON, A U.S. SENATOR FROM KENTUCKY

Senator **Huddleston**. Mr. Chairman, the hearings which this subcommittee begins today under your leadership will afford us the opportunity to determine the kind of job the Commodity Futures Trading Commission has been doing in regulating futures trading.

The necessity for fair and effective regulation of futures trading cannot be overemphasized. The futures markets are an integral part of the Nation's economy, and it is imperative that the markets be free from fraud and manipulation.

As the authorizing committee and the committee that in 1974 took the lead in establishing the Commodity Futures Trading Commission as an independent regulatory commission, it is important that we review closely the work of the Commission and determine what changes should be made in the Commodity Exchange Act to enable the Commission to do a better job.

Too, it is important that we, as the authorizing committee, review the statute to determine whether any of its provisions are outmoded and should be modified to accommodate the needs of farmers, businessmen, investors, and consumers.

The Commission has, of course, submitted its request bill. Other specific proposed amendments have been developed by the futures trading industry. The National Futures Association has also submitted a draft bill containing the statutory changes it believes should be made.

From what I have read in the press, some of the changes that have been suggested will likely prove to be controversial. And, given the amount of time Congress has to devote to the task this year, we may not be able to correct every perceived defect that critics see in the Commodity Exchange Act.

However, I am confident that we will make those changes that are necessary to insure the continuation of a strong and fair regulatory scheme to protect the users of our futures markets.

I am also hopeful that we will be able to make any changes that would be of particular benefit to the Nation's farmers. In this regard, I am looking forward to the testimony of witnesses on whether Congress should remove or modify the existing prohibition in the statute against the trading of options on agricultural commodities.

Senator LUGAR. Mr. Johnson, will you please proceed with your testimony?

STATEMENT OF HON. PHILIP McB. JOHNSON, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION, ACCOMPANIED BY DENNIS DUTTERER, GENERAL COUNSEL; TOM LOUGHRAN, DIRECTOR, ENFORCEMENT; JOHN MANLEY, DIRECTOR, TRADING AND MARKETS; JIM CULVER, DIRECTOR, ECONOMICS AND EDUCATION; AND SUSAN WAGNER, EXECUTIVE DIRECTOR

Mr. JOHNSON. Thank you, Mr. Chairman.

I have two preliminary matters that I would like to take care of. I have a supplemental statement that I would like to file for the record for the purpose of detailing the legislative proposal.

Senator LUGAR. Without objection, it will be included.[1]

Mr. JOHNSON. Again I would like to take this opportunity to introduce one of my fellow Commissioners, a very distinguished former Chairman of the Commission, James Stone, in the second row.

Senator LUGAR. The subcommittee is delighted to have the former Chairman.

We certainly enjoyed working with him and appreciate his specific contributions.

Mr. JOHNSON. Very valuable asset to the Commission.

Mr. Chairman, the reauthorization process involves an examination of both the past and the future. The past has received great play in the press lately, sometimes in a sensational and distorted way. The proper place for sober and responsible review, however, is right here. As to the future, we have prepared legislative recommendations—contained in S. 2109—that if enacted will greatly enhance the Commission's credibility as an enforcer of the act's requirements, and as a provider of services to both the public and the industry.

The Commission does not want for enforcement tools; and so we are not asking for any new forms of penalties. Rather, we seek merely to extend our existing enforcement "reach" into those shadowy crevices where violators now find shelter, and to those whose disregard of sound management practices inevitably sets the stage for public injury. We seek to attach to our existing weaponry a telescopic sight, in effect, so that violators can be more precisely targeted and the law-abiding business community can be spared the burden of layers of new regulations.

---

[1] See p. 294 for the supplemental statement of Chairman Johnson.

With respect to services, the Commission proposes to streamline its procedures in handling registrations, exchange rules, and reparations. Quicker service is the objective of each of these changes. We have not asked for statutory changes where servicing problems can be solved administratively, such as in the processing of new futures contract proposals which has been improved markedly in recent months. For this reason, and because new contract proposals differ radically in quality, completeness, and complexity, we do not favor imposing a fixed time limit on the processing of contract applications.

Before proceeding, I would like to address some of the observations and recommendations that appear in the draft report of the General Accounting Office. At the request of the GAO, we will be filing comments with it before the report is finalized and will be happy to share those comments with the subcommittee. First, many of the recommendations are the same as our proposals in S. 2109, even though we framed those improvements prior to receiving GAO's draft report. These include a revamping of the reparations program; an extension of registration to principals and key employees of commodity firms; authority to share information with State agencies for law enforcement purposes; and other matters. Second, steps to implement more than 30 actions recommended by GAO were already taken prior to the report, such as a fingerprinting requirement for applicants that is scheduled to take effect this summer. And we have taken actions, such as approval of the National Futures Association, to strengthen industry self-regulation. In addition, we are finalizing extensive rule enforcement reviews at the Nation's two largest contract markets—accounting for about 80 percent of all futures trading. Finally, we are in the midst of a concerted campaign to enlist the aid of the States in attacking off-exchange commodity frauds, as well as to expand their powers through S. 2109.

Were we to chide the GAO, and we would do so only with the greatest respect and admiration, it would be for failing to highlight adequately the progress made by the Commission under my predecessor and since. And there are some mistakes in the report as well which will be incorporated in our comments to GAO.

Mr. Chairman, the more lengthy statement filed with the committee today provides a detailed explanation of our legislative proposals. At this time, however, I would like to focus on several of our recommendations. I would also be pleased to discuss with the committee in detail, if it wishes, certain issues outside our legislative proposals, such as margin setting authority, private rights of action, judicial review of the Commission's emergency orders, and agricultural options.

On the enforcement front, the Commission recommends several key changes. It asks that there be greater accountability for persons within an organization who control the practices that give rise to violations of the act. Frequently, there are individuals within the company who knew or should have known of the particular misconduct but who shield themselves from accountability behind the corporate veil.

In the same vein, most principals and key employees of commodity pool operators and commodity trading advisers are not now required to register with the Commission and, as such, do not undergo "fitness" checks, may not be chargeable for fraud under section 4o of the act, and are immune from reparations claims. We propose to assure their accountability as well, by requiring them to register as associated persons.

A third area of insufficient accountability pertains to futures commission merchants operating through networks of "agents" rather than through their own branch offices. Agents are organized and owned separately from the FCM, and have management independence. However, their function is to procure business for the FCM, just like branch offices. Sales abuses and other violations have occurred at the agent level, but FCM's have been known to disclaim any responsibility for those offenses. The Commission considered creating a special registration category for these agents, with capital requirements and recordkeeping or reporting duties similar to but less extensive than those now applied to FCM's. This approach is similar to that which has been advocated by certain industry representatives. However, the Commission rejected that approach because of the burdens that it would impose, especially on the many individuals and small businesses now acting as agents.

Instead, we are proposing that agents be registered as associated persons of the FCM, just as branch office personnel are now required to do. The industry's principal objection—that these agents may ignore FCM customer protection policies—is also the most compelling reason to proceed as we have. The FCM continues to have the option which it can—and should—exercise to terminate any agent who refuses to comport himself properly.

Our enforcement "reach" would be enhanced in other ways as well. The Commission, for instance, would be empowered to bring actions to enforce the speculative position limits set forth in exchange rules. As you know, the Commission has directed each contract market to adopt speculative position limits for all contracts, subject to Commission approval. With enforcement authority shared by both the exchanges and the Commission, double protection would exist against violations of this critically important class of rules.

One of the enforcement proposals of which we are most proud is what I call the "open season" provision. The proliferation of con men offering phony investments in nonexistent commodities is a serious problem. Under our proposal, every Federal and State law enforcement agency would be empowered to use any available law, regulation, ordinance, or other tool at its disposal to attack off-exchange frauds masquerading as "commodity" investments, such as in strategic metals, diamonds, coal, and the like. Similarly, these resources could be used against any person who has failed or refused to comply with the Commission's registration or designation requirements. To aid in this battle, as well as to assist States and other agencies in the use of the tools now available under section 6d of the existing act, we are asking for authority to share with them sensitive information, now restricted by section 8, for law enforcement purposes. We also wish to share this information with bankruptcy trustees and receivers who are attempting to marshal the assets of financially troubled commodity firms for distribution to customers. Finally, we seek authority to obtain ex parte injunctions to preserve a firm's business records and to prevent the theft of customer funds when, in our judgment, it appears that prior notice to the suspected violator could result in the destruction of records or the disappearance of customers' funds.

I have now summarized the principal proposals of the Commission relating to enforcement matters. But there remains to be discussed the Commission's other critical role, as a provider of services to the public and the industry. Here, our recommendations are designed to streamline and to simplify.

The Commission registers tens of thousands of industry professionals. We propose that the Commission be authorized to grant temporary licenses, before the registration process is completed, to those who appear to be eligible based upon their applications. This would avoid the hardship now suffered by those who cannot work while their registrations are being processed. We also propose to be able to grant conditional registrations, such as a registration dependent upon special supervision. And we are recommending the creation of specific statutory disqualifications under which the Commission could dispose quickly of manifestly ineligible applicants.

With respect to contract market rules that must now be approved by the Commission before they can be put into effect, we are recommending that only contract terms and rules of major economic significance be made routinely subject to this prior approval requirement. Other rules would be automatically effective after 10 days of the filing date with the Commission unless, within that time, the Commission decides to review them for approval or the exchange asks to have them reviewed. This should release a substantial percentage of contract market rules from the prior approval process, allowing earlier implementation than is possible today.

With regard to the Commission's reparations program, which has produced disappointing results, the Commission proposes two changes. First, that we be authorized to redesign the program through rulemaking, in order to eliminate delays and cumbersome procedures now built into the act. The new procedures would comport with fundamental fairness, but would improve the efficiency of the program. Second, the Commission proposes that the program be limited to claims against persons who are registrants under the act. At present, the program is required to entertain claims against nonregistrants if they should have been registered with the Commission. These individuals or firms are typically unknown to the Commission, and many are in bankruptcy or receivership by the time when reparations claims are filed. And because these persons have not registered, the Commission is unable to monitor their business practices for the purpose of reducing customer complaints against them. It is virtually impossible to intelligently manage the program as long as it is vulnerable to sudden surges of claims against previously unknown respondents and, even when these cases are decided, the awards are frequently uncollectable. The entire reparations program suffers from these unexpected shock waves, to the detriment of claimants generally.

All of these streamlining proposals are intended to conserve the Commission's resources as well as to improve its services. But these steps will not be a cureall for the Commission's perennial resource problems. More is needed and, for that purpose, the Commission proposes to establish a transaction based fee. Before addressing that proposal, however, allow me to provide some background.

In the last 5 years, futures volume has nearly tripled. The contract markets have kept pace by increasing their budgets dramatically and by expanding their facilities. Many have inaugurated transaction based fees of their own during this period. Meanwhile, the Commission's budget has increased at an annual average rate of only 4 percent, which is below the rate of inflation. Its personnel has grown by only about 1 percent a year, on average. While the Commission has coped with these limitations so far, its ability to do so in the future is highly doubtful.

Accordingly, the Commission is proposing that a statutory transaction based fee be adopted. An amount equal to 6 cents per side, long or short, would be assessed to each contract market for each futures contract and exchange-sponsored option traded for the account of an exchange member or a member of the National Futures Association. A 12-cents-per-side fee would be paid for futures and exchange-sponsored options made for the account of a nonmember of that market or for a nonmember of the NFA. This two-tier fee system is intended to give due recognition to the contribution already being made by exchange members and that will be made by NFA members to self-regulatory programs.

In the case of dealer options and leverage contracts, the grantor of the option and the leverage vendor would pay a $3 fee for each instrument sold.

All of the fees would be paid annually to the U.S. Treasury, rather than to the Commission, so that the Commission would remain fully accountable to the Congress through the appropriations process.

Since a transaction based fee of this nature is new to the Commission, we are proposing several safeguards. First, the fees would not be permitted to exceed the Commission's budget, regardless of volume growth. Second, the fees would be set by statute, so that any increase would require congressional action. Third, the Commission would be authorized to reduce, suspend, or waive any part of the fee if it is having an adverse effect upon the functions of the market. For instance, a fee could be reduced, suspended, or waived by the Commission if it were having the effect of imposing prohibitive cost on classes of hedgers or market makers. And, finally, a new advisory committee would be created, consisting of persons impacted by the fees, to detect inequities in the system, to counsel the Commission on the need to reduce, suspend, or waive a fee, and to prepare a comprehensive study of the fee system for submission to Congress by June 30, 1985, at which time the advisory committee would dissolve.

The Commission is keenly aware of statements that the transactions fee that we propose may so erode the industry's support for the National Futures Association that it would have to be aborted.

The Commission believes that such a result would be tragic, not only because of the great promise that the NFA holds for the future, but because it would be a major setback in the evolution of self-regulatory programs that could assume roles now played by the Commission. It could also raise doubts about the industry's commitment to self-regulation, especially if self-regulation is viewed by the industry as little more than a dollars and cents proposition. The Commission's hope is that the NFA will indeed supplant certain of our programs and reduce our need for ever-increasing budgets. It is precisely for that reason that our proposal requires us to seek annual appropriations from Congress, which could be modified as the savings from the NFA are realized. But, for the present, we see no other solution to the Commission's immediate and near-term resource needs, as Federal belt tightening and explosive industry growth converge on one another.

Another important feature of our legislative recommendation relates to the jurisdictional accommodation reached by the Commission with the Securities and Exchange Commission in December of last year. As you know, the jurisdictional lines between the two agencies have been disputed for nearly 8 years among the two Commissions, in Congress and in the courts. A new atmosphere of cooperation and cordiality now exists between the Commission and the SEC, and is reflected in our proposals to codify the joint accord.

Under these proposals, the Commission's exclusive jurisdiction over all futures trading and all options on futures would remain intact. In the area of options directly on securities, the SEC would be the sole Federal regulation. In regard to stock index futures, additional standards are created and special procedures are set to assure adequate SEC input—but not a veto—in the approval process. Those standards and procedures have already been followed during the Commission's recent approval of the first of several stock index futures proposals. In the case of futures on individual corporate stocks or bonds, and on municipal securities, we are proposing a moratorium so that the two agencies can reach a final decision on regulatory assignment. No such futures are being traded at the present time. Finally, with respect to options directly on foreign currencies, the SEC would regulate only those traded on a national securities exchange, while the Commission would regulate currency options elsewhere. We believe that this agreement is a sound one and a fair one. We earnestly urge the committee to support it.

We also understand that representatives of the industry have urged that the Commission's emergency orders, including the reasoning behind them, should be subject to immediate attack in the courts. Since 1974, the Commission has used its emergency powers only four times: during the 1980 Russian grain embargo; and in three specific market situations. Our emergency orders impacted trading on only 25 of the roughly 2,000 days when trading has occurred since the Commission came into existence, and trading was actually halted on only 3 days. This is due to the fact that the Commission has always viewed its emergency powers as a tool of last resort and has tried to adhere to the statements of the Congress that those powers be used only when compellingly needed. Because of that policy, emergency actions are not taken by the Commission until all other recourse has been exhausted, the crisis is at hand, and timing is everything. Were it necessary to factor in the time required to prepare an exhaustive defense of the contemplated action, with witnesses, documents, and court pleadings, either the timing would have to be delayed or the action would have to be accelerated. If delayed, the emergency action could be too little, too late. And if the Commission were to act hastily, in order to allow time to prepare for litigation, a far greater disservice to the markets would result. These same considerations would apply to the emergency actions that the exchanges themselves take and, indeed, take far more often than the Commission. For that reason, the Commission has never stepped in to block an exchange from taking emergency action, as the industry proposes to achieve against Commission actions.

Let me close with several personal observations gained since I joined the Commission last June. I am extremely impressed by the Commission's staff. In my judgment, it is the equal of any professional group that I encountered in the private sector. I am also grateful for the contributions and cooperation that I have received from all of my colleagues on the Commission. Without their support and dedication, the gains of recent months would not have been possible. And I have acquired a sobering appreciation of how long and how difficult a task it is to overcome adverse preconceptions about the Commission. Finally, I have been aided immensely in my new position by the wisdom and encouragement that you, Mr. Chairman, and other members of this committee have given to me.

Thank you.

Senator **Lugar**. Thank you very much for that testimony.

I would now like to call on Senator Roger Jepsen who has joined us and who has an opening statement, and also I understand a time deadline.

Senator Jepsen, if you want to start with any questions, please do so while you have the witness.

STATEMENT OF HON. ROGER W. JEPSEN, A U.S. SENATOR FROM IOWA

Senator **Jepsen**. Thank you, Mr. Chairman.

Mr. Chairman, the Wall Street Journal and others have called for the dismantling of the Commodity Futures Trading Commission. They suggest a better idea would be self-regulation by the various commodity exchanges.

I will not go so far—at least at this time—as to recommend that the CFTC be abolished. For one thing, I have some serious reservations on the ability of the various exchanges to police themselves.

But I will say this, there is growing discontent on CFTC's ability to provide adequate protection to its commodity customers.

The futures markets play a critical role in the activities of farmers, processors, merchandisers, and exporters of agricultural products. Nearly one-half of the futures contracts traded on all exchanges are for agricultural commodities.

Back in 1979, I, along with several of my colleagues on the Senate Agriculture Committee, attempted to stress to then President Carter that, and I quote, "Increasingly, transactions in agricultural commodities regulated by the CFTC have come to have an important impact upon the economic health of American agriculture." That statement is as true today as it was then.

I recognize that, in the few short months he has been on the Commission, Chairman Johnson cannot have been expected to perform miracles, but I will be interested, as will others, in having the chairman place on the public record just what has been done to improve the CFTC's image as well as to protect traders.

I might add and inject at this point that I was most impressed with your candid remarks here, with some of the things that you have already put on the front burner.

Judging from recent news reports, I think we both agree that the image part of the CFTC can still stand vast improvement.

I would like the chairman to spell out for the record what has been done—since the silver trading controversy of 1979 and 1980—to assure that existing exchange rules provide adequate assurances that exchange board decisions are the result of fair deliberation.

I would like set out for the record just what is being done in the area of establishing conflict of interest standards for members of the exchange boards. That is a key to the integrity of the industry. It is a key to the CFTC's image problem.

In an interview in July of 1980, then Chairman James Stone said the possible conflict of interest issue, and I quote, "is an important subject for the CFTC to look at * * * we will be doing so at some point in the near future, but it's not easy."

I would like to have on the public record whether any progress has been made in this area.

Newspaper reports of the past several days indicate that while futures trading has grown by leaps and bounds, the CFTC's surveillance of market activities has been superficial at best. I am concerned over that point. I would appreciate your comments with regard to the GAO report and its charges.

It is a serious indictment when the General Accounting Office charges—as it has done—that the CFTC is failing to adequately monitor the rules and regulations concerning the Nation's 11 futures exchanges. It is about time—in fact, long overdue—that the Commission moves in this direction to focus more on what the GAO report pointed up as, and I quote, "the substance of rule enforcement."

I was disappointed to hear that the CFTC is actually spending less of its time on such reviews. Is the CFTC, as GAO official Henry Eschwege testified before the House subcommittee, more concerned about whether rules exist than how well they are working?

Let me quote from that testimony: "It concerns us that the Commission continues to approve expansion of trading before it more fully develops its monitoring, evaluation and enforcement programs to protect the integrity of existing trading."

I will welcome development of testimony on whether the States should become more involved in the enforcement of commodity laws. Chairman Johnson has been quoted as saying that more power should be returned to the States, that his staff is too small to do battle with some scam businesses.

I would hope that this is not an attempt to draw attention away from the inadequacies, the failings of the Commission itself.

My first question would be just how many States are equipped to push into this area?

And how can the turf problem be overcome—with States being overly protective of their jurisdictions and the Feds too reluctant to share its work—its investigations with the States?

At this point, I am not entirely convinced that the CFTC, as mandated in its 1974 charter, has provided assurances that the trading futures contracts process is fair.

I also am not entirely convinced that it has protected not only the rights of trading customers but the integrity of the marketplace as well.

We talked about this earlier. It is a problem that agricultural producers have, it is on the minds of these people. They feel that the Futures Commission and some of the folks raising the money are, to use farm language, all in cahoots and they are all making money at the expense of the producers. I think that is a shame and I would—I know that you are concerned about that, too, but that is something that I hope that we could see some real progress made by way of education and reassurance and attention to some of these points that are brought up here, both to relieve and correct that. I feel that and know that in times like these, some sophisticated and some prudent use of things that are available in the financial world and through the Commodity Futures Trading Commission—parts of farming which is big business—could be very helpful in the proper uses of hedging and this type of thing. It is a business area and a financial area that I think, among other things, that your Commission should be taking a real hard look at and take action on. And together, to take a leadership role at least in providing education, as to how these commissions and these boards can be used to do a better job of financial management for the producers and some of the processors and so on.

I think that is a proper responsibility for the leadership of your Commission. I appreciate, Mr. Chairman, the chance to make this statement to this committee. I think you are sharing this and developing these hearings, and I am glad it is in your hands. It is extremely important to the agricultural community in general—the activities that the CFTC has in this area—and it is probably one of the most important things that comes out of this session.

I thank you for your work on it. And I offer any help that we can give in my office.

We are really interested in whether this reauthorization process will be the CFTC's sunset or sunrise, and it will depend entirely on how well the Commission and others develop for the public record the responses to these concerns.

I thank you very much.

Senator LUGAR. Thank you very much, Senator Jepsen.

Before I ask you for a response, Mr. Johnson, Senator Boren, who is the ranking member on our subcommittee, just entered. I would like to recognize him.

STATEMENT OF HON. DAVID L. BOREN, A U.S. SENATOR FROM OKLAHOMA

Senator **Boren**. Thank you very much, Mr. Chairman, and I apologize for interrupting.

I am sorry that my schedule is not going to allow me to be here with you this morning, but I want to assure you that I am going to read the testimony carefully and fully consider the suggestions which you are making today. And we appreciate your appearance before the committee and the study which you have given this issue, and the recommendations which you are making.

Mr. Chairman, I want to commend you for conducting these hearings because you are dealing with an extremely important matter, the reauthorization of the regulatory program.

It will give us a chance, I think, to consider some very important questions, including the role that futures trading plays in our commercial and financial economy, and the nature and effectiveness of the self-regulatory mechanisms in the futures industry and the type and extent of Federal regulations that are needed.

These are very important issues, not only for those involved in the trading itself, but for the whole agricultural sector as well. And I look forward to participating further in these hearings and ask that the balance of my statement be included in the record.[1]

Senator **Lugar**. It will be so ordered.

I look forward to working with you in trying to develop reauthorization legislation.

Senator **Boren**. Thank you very much. I apologize that I was otherwise scheduled this morning, but I will read the testimony very carefully.

Senator **Lugar**. The Chair would like to recognize Senator Bob Dole for a statement or questions or general participation.

STATEMENT OF HON. BOB DOLE, A U.S. SENATOR FROM KANSAS

Senator **Dole**. I have no prepared statement. I am here to indicate my interest in strengthening the CFTC. I think, as Senator Jepsen and Senator Boren and certainly the chairman indicated, we have a direct interest coming from farm States. In addition, we have another parallel interest being responsible for oversight of the CFTC. We want it to work, and I believe that you are doing an outstanding job as the chairman and we will see some needed changes.

I have read your statement and I share the view that maybe GAO should have recognized that there are many areas that were being addressed. And I am also aware of some of the theatrics that goes on in the Senate from time to time. I did not participate in that particular one the other day. We do some of our own. To include people who are involved in fraud only, may leave the wrong impression as to how the Commission operates and how it could operate.

There is enough skepticism and suspicion without creating more, and I do not think that was the purpose of the hearing earlier this week, but that is what I got out of the media report, which does not mean much generally. Some people think it does. I may have some questions later. Were you going to respond to Senator Jepsen's comments?

---

[1] See p. 293 for the prepared statement of Senator Boren.

Senator **BOREN**. Mr. Chairman, I do have some questions that I would like to submit for the record and they may be answered for the record.

Senator **LUGAR**. Will you submit a response to Senator Boren's questions?

Mr. **JOHNSON**. Yes.[1]

Senator **LUGAR**. Do you have a comment getting into the question—either on the statement or questions of Senator Jepsen or Senator Boren?

Mr. **JOHNSON**. Yes, if I could take about 5 minutes, I would like to respond briefly.

Senator Jepsen's concerns are real and they are certainly on target. The problem that has arisen in terms of the Commission's image and, in fact, the image of the entire industry is largely the fact that a clear distinction has never been made, never, between the legitimate industry and the criminals out there who pretend to—they do not even attach themselves to the industry—that pretends to be operating under the mantle of the industry.

The hearings earlier this week helped highlight the fact that there is confusion between the industry that the Commission is charged to regulate and the lawless elements that operate perhaps in the commodity areas this year and in real estate next, and in securities the year thereafter.

It is a difficult problem for the Commission or for the industry to overcome that vagueness of the lines between its activities and others. It does rub off on both the Commission and on the industry, and I frankly have no quick solution to that problem.

It was suggested the other day that registration requirements that we have do, in fact, create the possibility for someone to use that registration, rather abuse the registration, to lull the public into a sense of confidence when, in fact, the individuals engaged are engaged in unlawful activity. So even in our attempts to confine the industry to the legitimate operator, there are occasions when some steps will be taken in the best motives. Instead, they are abused by others.

I feel confident that the legitimate industry, and it is a very large industry—I am not speaking of a few people—operates in a generally honest and forthright way. We have had infinitely fewer problems in the enchange community, and the legitimate brokerage community, than we have had with these scam operators. We have taken, however, from time to time, severe steps. Last year we assessed a penalty of half a million dollars against a group of traders. We have sanctioned one of the exchanges with $200,000 in civil penalties, plus ordering them to revamp their structure. That has happened as well.

We have two rule enforcement reviews pending at this time of the two largest exchanges in the country, which should be ready shortly. I do not agree that there is any reduction by the Commission in its proper oversight and regulation of the legitimate industry. I think, if anything, our record is improving day by day.

---

[1] See p. 101 for the questions submitted by Senator Boren and the answers thereto.

As far as the concern that Senator Jepsen had with respect to the attitudes in some areas of the agricultural community, that has been a very, very long standing problem since I took office, and I know that Commissioner Stone confronted the same problem.

I have met more than 20 times with agricultural groups in an effort to be certain that we are familiar with their concerns and to acquaint them with what we do and why. On two different dates, we gave agricultural groups a briefing on our legislative proposal. So we are trying to be sensitive to those concerns. We are trying to also increase in some manner the funds that we have available for education in this area.

We are pleased to hear that a number of agricultural organizations are now setting up substantial educational programs in this area which have been very, very helpful. But we are working on these problems and we are attempting as best we can to keep the lines of communication wide open to the agricultural community in the hope of reducing the misconceptions that may exist as to the role of the Commission and the nature of the industry.

Senator LUGAR. Thank you, Mr. Chairman.

Senator Dole, let me just converse with you for a moment on procedure at this stage. I have a list of questions which will consume most of the morning. If you have a shorter list, why please proceed, or if you want to share back and forth any time, that would be fine, too.

Senator DOLE. I think you can go ahead.

Senator LUGAR. I will proceed then with a couple of areas and then I will yield to you and we will proceed in that way. Because this is the initial hearing and you are in a good position to try to illuminate many, if not all, of the issues that have been raised before the subcommittee, I want to take this occasion to ask the questions. Senator Jepsen and Senator Boren have left additional questions which may be covered in this area or which may not. We will have to sift those out so that our hearing record is complete.

One of the issues that you highlighted on about page 13 or thereabouts in your statement this morning was the judicial review of the Commission's emergency powers. This clearly is an extremely important issue as the exchanges see it, and you mentioned during the course of your statement that such emergency powers had to be invoked about four times, and you went through those instances.

During the hearings on this same reauthorization with the House of Representatives, it has been suggested that judicial review of the powers might be linked to giving the Commission emergency power to set margins. Do you believe the CFTC already has this power, or do you have a comment on that suggestion?

Mr. JOHNSON. It is our position that the Commission already has that power and has exercised it on one occasion that I am aware of.

Senator LUGAR. Why did the Commission not use its emergency powers during the so-called silver crisis a year or two ago?

Mr. JOHNSON. Mr. Chairman, I am at a disadvantage answering that question because I was not here at the time.

I would like to supplement for the record.[1]

---

[1] See p. 42.

Senator LUGAR. If there is no judicial review of the powers, what check is there on the Commission's authority?

You stated as a matter of philosophy that the Commission has seen this as a last resort, but is it possible that another set of Commissioners under other circumstances might use these powers in a different way? What sort of checks and balances is there in the scheme of things with regard to these emergency powers that the courts are not involved in authority here?

Mr. JOHNSON. It is a question of attempting to try to weigh the risk on the one hand that the power might be abused against the risk that judicial review might neutralize and make futile the procedure as a whole.

Our argument is that in balance the better approach is to allow the Commission to issue these emergency orders on a judicious basis, allow them to go into effect so that the marketplace participants are aware of what the new rules are. So that we are not in a position of having to be concerned as we have, and as I have indicated earlier, our intention is only to act at the last moment when all else has failed. So that we are not forced in the position of having to act too early in order to get our lawyers prepared to go to court in the inevitable Sunday afternoon hearing that would ensue. We do not want to jump the gun and, at the same time, we do not want to delay the effectiveness of the order beyond the timing that we think is critical.

It is a practical problem as much as it is anything else. We would probably have to take an action perhaps 2 or 3 days before it is really needed, during which period perhaps some other corrective steps might have been taken, if we are required to prepare for litigation.

As I indicated in my statement, we recognize the dilemma that even the exchange faces in their powers if the Commission were to stand astride the process and tell them yes or no or block their attempts for emergency authority. We have never done that and we have not done it for precisely the reasons that the timing is critical. We do not want these exchanges to act earlier or later than necessary.

Senator LUGAR. You mentioned this does have a practical side to it.

What would have been the effect to take, let us say, the Soviet grain embargo question that arose at the time of Afghanistan, and you mentioned this, that the Commission invoked emergency power. As a practical matter, what would have been the result in terms of trading or advantages or disadvantages to various people in the market if you had not had the authority to make emergency orders, make them stick in a sense of judicial review before that order might become effective?

I suppose without asking leading questions and trying to fill in all the answers, I want you to describe in essence either the chaos of the market or the lack of it or the ways in which people make a lot of money or lose a lot of money as a practical effect of this type of judicial review that is being proposed by some, or the emergency order that the Commission is now able to invoke?

Mr. JOHNSON. I am not as conversant with the Russian grain embargo situation as I would like to be, but I could give you an illustration of what occurred there.

The President announced an embargo of grain. At that point, very substantial export contracts were effectively being voided. That meant that what, in fact, began as a substantial part of the demand for grain was suddenly no longer present. The expected result of that on the futures market would have been a very sudden and steep drop in the price of grain. At the same time, the President had indicated that, in conjunction with the Secretary of Agriculture, they were working on a plan to soften the blow of that for American exporters. So it would appear at the time that the Government was going to take steps that would go quite a long way toward neutralizing the market impact of that situation.

The Commission acted to halt trading in the grain complex on the futures market during those 2 days following the President's embargo, 2 trading days, because of the fact that, in all likelihood, what would have happened there would have been a sharp drop in prices, the first trading day, and as the details of the President's procedure for neutralizing the procedure came out, the price would rise again to some level. This had no relationship whatsoever with the true supply-demand conditions of the market. But there was a reaction to one Government action and then, subsequently, reaction to another Government action. So the markets were not going to be able to do anything like telegraph the Iowa prices, and it was felt that particular people who were long in the markets, that a major drop in the price would have resulted in massive margin calls only to have them subsequently get their money back, presuming that they could survive the 2 days. And many would not be able to survive the 2 days. So, to even out the market, in a fashion that the President was attempting to even out the problem with the embargo, the markets were closed. If the affected exchanges had sought judicial review and prevailed on the court not to permit the emergency to go into effect, gyration would have taken place. A number of people would, in all likelihood, have been hurt, and meanwhile the agricultural community was sort of holding fast to await the outcome of the President's corrective steps. So the agricultural community, in all likelihood, would be on a standby basis and the futures market would be behaving like a Yo-Yo.

Since the objective of the futures market is to reflect what has transpired in the agricultural community, the result would have been that the futures market would have acted wildly, while the agricultural community was on a standby basis.

Senator LUGAR. Thank you.

The Chair would note that Senator Hayakawa of California has joined the hearing.

Do you have an opening statement or any comments, Sam, or do you want to read this for a period?

Senator HAYAKAWA. No, I really do not. This is an area that I grope for understanding so I am here to understand.

Senator LUGAR. We all are in that condition here this morning, and we are working along together.

Senator Dole, do you have questions that you would like to ask?

Senator DOLE. No. I think if you just continue, and then if I have any——

Senator LUGAR. Fine.

Let me question in the area of user fees.

You quoted, quite properly, in your statement to the rationale for the fees that are a part of S. 2109, but why were the figures of 6 cents and 12 cents per contract chosen and what share of the CFTC budget would be generated from such fees?

Mr. JOHNSON. Well, the selection of 6 cents and 12 cents was a combination of a certain amount of judgment and some attempt to calculate what the return would be on those numbers.

The judgmental factor was an attempt to keep the fees at a level that appeared not to be of any particular economic significance to most of the participants in the market. Many of the exchanges have the same sort of fee system and their fees are substantially higher than that.

The second consideration having to do with projecting revenue was based upon 1981 trading volume, which is in the vicinity of 100 million futures contracts, attempting to determine which percent of all trading would fall in the 6-cent category and what percent in the 12-cent category. We calculated that we would raise something in the vicinity of $15 million, which is roughly two-thirds or slightly more of our 1982 budget.

Senator LUGAR. Two-thirds, you say?

Mr. JOHNSON. Roughly two-thirds. It might be slightly higher than that. But it would be roughly two-thirds of the 1982 budget.

The way this industry is growing, in all candor, I will have to admit that if the volume were to grow much more it could probably be 100 percent of the Commission's budget. It is for that reason that we are recommending a ceiling so that the fees would never exceed the Commission's budget.

Senator DOLE. Could I just ask——

Senator LUGAR. Yes.

Senator DOLE. Are you getting a lot of support for this from the industry?

Mr. JOHNSON. I have invited support, Senator, and I have not had any takers yet.

Senator DOLE. I am chairman of the Finance Committee; I cannot find anybody who wants their taxes increased either.

I thought maybe if you were getting some results, I would see how you did it.

Mr. JOHNSON. No success whatsoever.

Senator DOLE. But they would not jump ship if it happened anyway, and I assume they would have to comply. I think it is a serious question; we are trying to figure out how to get a handle on the cost.

Who should pay, the taxpayer or those who use the general services? I could understand anyone's opposition to paying a transaction fee or user fee.

Mr. JOHNSON. We haved tried to keep the numbers low enough, as I indicated earlier, so it would not be a hardship to a vast majority of the people in the market. But realizing that there may be some large hedges or some of the large traders who could be impacted by this, we have also built in a protection, namely, the opportunity to reduce, suspend, or waive the fee to even out those types of inequities.

We do not have any experience with this fee and we are not altogether clear what the impacts might be on the very large traders.

Senator **Dole**. Do you think that might drive some traders away from our markets, possibly to foreign markets in Europe? That has been one question raised by the industry. One ghost, I guess.

Mr. **Johnson**. I would doubt that very much. For years and years we have been told that American regulation was going to force business abroad and there has been no indication of that occurring.

Senator **Dole**. Thank you, Mr. Chairman.

Senator **Lugar**. Just as a practical question again, the 6 cents and the 12 cents contract fees that have been mentioned, what is the base on which those would be levied, a contract chosen?

Describe if you will a contract, let us say for corn.

How much money is involved in that sort of contract or could be involved?

Does the 6 cents apply to the contract regardless of the number of dollars involved, can you give us some idea of what sort of money the ordinary trader might be running into on this?

Mr. **Johnson**. Well, it would be assessed on a contract unit basis irrespective of the value of the contract.

Senator **Lugar**. Or the commodity?

Mr. **Johnson**. That is correct. It would be across the board. It would be the same on a Treasury bond contract as it is on a soybean contract.

The economics of the industry at the moment are roughly this: If I were a customer, I would probably be told that I have to put up, let us say $2,500 in margin; that I have to pay a commission charge of $50; that the exchange has assessed, which may be buried in the commission, a transaction fee of its own; and under this program, the customer would be advised, if the firm wanted to pass it on to him, that there would be another 6 cents per side or 12 cents round turn charge to them in order to support the operation of the Commission.

Senator **Lugar**. Now, just to be——

Senator **Hayakawa**. Six cents on the whole transaction?

Mr. **Johnson**. Six cents in or six cents out for a total of twelve.

Senator **Lugar**. You put up $2,500 in margins?

Mr. **Johnson**. Yes.

Senator **Lugar**. And the brokerage fee is $50?

Mr. **Johnson**. That is right.

Senator **Lugar**. You pay that to whoever is handling the trade for you?

Mr. **Johnson**. That is right.

Senator **Lugar**. In addition to that, if you bear the incidence as customer, you could have another charge of 6 cents or 12 cents for the round trip?

Mr. **Johnson**. That is correct. It might be shown separately or it might be added into the commission charge.

Senator **Lugar**. But the net effect of all these 6's and 12's, if you had 1981 volume, would be you would have about $15 million of revenue?

Mr. **Johnson**. That is correct. Based upon our assumption of about how many people would be in the 6-cent category and the 12-cent category.

Senator **Lugar**. The revenue goes to the U.S. Treasury?

Mr. **Johnson**. That is right.

Senator **Lugar**. So the Commission stays in the appropriations process?

Mr. **Johnson**. That is right.

Senator **Dole**. Could I there?

Senator **Lugar**. Yes.

Senator **Dole**. What other alternatives are there in addition to the way we are doing it now? Would one alternative be to abolish the CFTC?

Mr. **Johnson**. That would be another way to save $20 million, exactly.

Senator **Dole**. The industry would not support that either. If you gave them a choice, which would they prefer?

Mr. **Johnson**. I would think that the overwhelming view of the industry would be that they would prefer the Commission without the user fee.

Senator **Dole**. They cannot have it both ways. They really can't.

Senator **Hayakawa**. Mr. Chairman, it seems to me it is 6 cents one way and another 6 cents the other way, or 12 cents. This is less than the cost of the postage stamp. Very much less. So why should there be any objections at all? The assessment is even less than the cost of a phone call.

Mr. **Johnson**. I think the concern fundamentally focuses in on large traders where this could add up to a significant amount of money, several thousands of dollars and perhaps more than that per year.

Senator **Hayakawa**. But that is true with telephone calls, too?

Mr. **Johnson**. That is right.

Senator **Lugar**. What is the reason for the differential in fee for members and nonmembers, at how to arrive at staff rationale? That should be 6 cents for the members and 12 cents for the nonmembers?

Mr. **Johnson**. Again, it was largely judgmental. The members of the exchanges, the 11 exchanges are making a significant contribution to their self-regulatory programs.

The new national futures association members will do likewise. We are attempting a variety of ways in the Commission to shift into this organization certain of our functions, which we hope over time we will be successful in doing. So their expenses are likely to rise.

We just simply made the estimate, perhaps as much as one-half of the expense is being borne by these people and as a result we wanted to reflect in some rough way our acknowledgment that they are in fact spending a substantial amount of money.

Senator **Lugar**. Now, you have touched upon that expenditure and it is an important one, I think, for the record, to show that the NFA will be reasonably cost experience—as I understand, $6 million to $9 million may be involved. We will be hearing from the industry as to how much money they anticipate they will be levying upon themselves to bring about better self-regulation.

To what extent, however, will the user fee, if it is adopted as part of this bill, or some other bill, stop the NFA?

In other words, will it be such a chilling proposition that the self-regulatory efforts will cease? What is your reading of it and we will hear from the industry, but I am asking at least that you take a look at it from the Commission's standpoint in asking of the fee?

Mr. **Johnson**. The Commission is supportive of the NFA. I think that of everything that has been accomplished since last summer, that is the one we may be the proudest of. We did not set user fees to create any threat to the future of the association. We did not think there was any logical connection between the NFA and the user fee. However, I am told that support for NFA may wane as the industry goes into effect.

The NFA has been created by the industry and it can be killed by the industry. However, our view is that the cost of regulation in an industry which is growing as explosively as this, as the numbers indicate, will only increase and the functions of NFA must be performed by someone. After so many years of the industry indicating that they would like to carry a greater share of that responsibility, in lieu of the Commission doing it, we now are evidently being told that that is not true anymore; that, instead, they would rather pay a user fee to the Commission and scuttle the NFA than support the NFA with their own funds.

I think what tends to be overlooked here is that the costs of regulations are determinable and they are rising, and that the situation with the Commission, the exchanges, and the NFA, is that each would have a slice of that pie. The pie will not shrink if the NFA does not come into existence; it simply means two slices instead of three.

We see no reason why the NFA should be jeopardized by this although the NFA appears to be held hostage now by this issue.

Senator **Lugar**. Out of curiosity, how much of the SEC budget is financed by the industry that it regulates? Or has that concept arisen?

Mr. **Johnson**. At the SEC there have been a variety of industry fees since the 1930's. They have a transaction-based fee which is related to the value of all securities traded. It is an infinitesimal amount, but it adds up to millions and millions of dollars.

These figures may not be entirely accurate. I will be happy to provide more accurate information, but I understand the transaction fee during certain very high volume years, when the SEC's budget was much smaller than it is today, actually exceeded the budget of the SEC. More recently, my understanding is that the fees on transactions cover roughly 19 to 20 percent of their budget and they also have registration fees for new issuance of securities which add another $40 million or $45 million to that. So in this $80 million of budget, they are getting perhaps two-thirds from industry-based fees.

Senator **Lugar**. Is the fee proposal that you have supported today in your testimony, supported by the administration that was worked out in consultation with the administration?

Mr. **Johnson**. It was worked out in consultation with the administration, particularly the Office of Management and Budget. It arose initially in the discussions of the 1982 fiscal year budget.

The proposal that we have submitted has been approved by OMB.

Senator **Lugar**. Well, I will not belabor this issue further, because I know it will be a subject of discussion throughout our hearings. I wanted to highlight it early on. It is not the purpose of the Chair today to testify for or against the thing.

I think Senator Dole has, in his own jocular or serious way, raised the heart of the matter that we have here a situation of obviously expanding industry and I think many of us are excited to see that occur, like the market system in this country. But there are demands that this situation be properly regulated in the public interest. The question of who is going to pay for something that is expanding, and people are making money, hopefully, they will make a lot more money, pay the taxes on the money to get our economy going, but who will do that, I think, is an important question.

The user-fee question arises in that context and I would say on behalf of you, Mr. Chairman, you were not the advocate of it. I can recall personal conversations where we tried to wrestle with this growing budget problem of how this all was going to be paid for. I am aware, and you have highlighted today, that there are all sorts of crosscurrents among people in the industry, outside the industry, and what have you, on these issues, on the NFA, and what have you.

I would hope that in terms of getting this authorization in a satisfactory way to the public, the public interest, that those involved in it not press too hard on this issue.

I would guess simply we are going to have to have revenue and it is not ultimately going to be paid for by the public. The whole thing is not going to be saddled onto the public.

So my own bias, I think, ought to be made clear.

We have a marvelous industry but that is not going to have to bear its share and I guess we will have to wrestle with that problem as to what its fair share is, but specifically this is the reason I have asked about the 6 cents, the 12 cents, the differentials, the SEC situation. There is clearly room for discussion here, but it ought to be clear that we need to proceed toward some assumption responsibility and I think that is what industry people would like to see.

Do you have any more questions in this area?

Senator **Dole**. No.

Senator **Lugar**. Let me ask about the GAO report and in this respect of course we are still going to have to fill in the record as you respond to things GAO had to say. And although you have highlighted some important point; namely, the report covering recent activities of your predecessor and yourself and your commissioners, several exchanges have proposed that the CFTC not be allowed to institute a proceeding against a person already punished by an exchange unless the CFTC finds that the punishment was inadequate in light of the defense.

Could you comment on that proposal?

Mr. **Johnson**. Yes, we are not in favor of—I think they refer to it as a double jeopardy provision. The reasons, Senator, are these: The Commission has at its disposal certain remedies that the exchanges do not have. Probably the most important of all is the injunctive remedy, which is nationwide, which follows that individual as he moves throughout his life, irrespective of whether he remains at the exchange or not.

The exchange sanction is only effective as to that individual's activities on that particular exchange. Frequently these offenses are in the nature that he should not be able by resigning from the exchange to clear his record and as a result we, because we have a nationwide ability to police these markets and can use the courts to get relief and permanent relief, we feel that there are a lot of instances where the exchange takes action where we need to use our powers as well, looking more to the future of the activities of the person.

Senator LUGAR. Several exchanges have proposed limiting the exchanges disclosure of information and to provide protection with regard to this information obtained by CFTC subpenas.

Could you comment on that proposal?

Mr. JOHNSON. Well, our current practice is that we will not release sensitive market information or names of customers or trade secrets or confidential information except under section 8(a) or to the Congress. And in court proceedings we always insist on a subpena.

There are instances where we feel that it is not in support of the objectives of the act to provide some of this information. We do not volunteer any of this information to private parties and will frequently resist a subpena in court for the purpose of explaining to the court the sensitivity of the data which might be released and as a result we frequently, if we do release information beyond the Commission we do so under protective order that it will not be abused.

Senator LUGAR. Some State securities authorize the information, have suggested that the CFTC require the industry to adopt a customer suitability use pattern after those used in the securities industry.

Would you comment on that idea?

Mr. JOHNSON. The Commission has struggled with the suitability rule for a number of years before my arrival and I cannot relate to you in any great detail the earlier deliberations.

The Commission, when it adopted the pilot program for options realized that options are a vehicle that could appeal to the average citizens and imposed a requirement that the brokerage house must make a diligent effort to understand who it is dealing with; whether this goes to the full degree to a suitability rule or not, I am not in a position to say. But it certainly has indicated a commitment on our part to require something akin to that standard in the case of options.

In the futures situation it is a bit different. There are roughly 30 million stockholders in the United States and they cover every conceivable strata of our society. They are brought into the securities market, in many instances, on the theme that it should be a part of their retirement plan or that it is something that they should do to augment the cost of educating their children. In other words, securities are often sold as a financial long-term financial planning device. Everyone knows, and I think this is probably more true on the street than it may be among more sophisticated people, that futures trading is a short-term, very high-risk business. I do not have exact figures but based upon a conversation I had with the president of a large brokerage firm recently, it would appear that the people of the type that are in the securities business—and there are 30 million of them, there may not be over 100,000 of them in the futures market.

I think that the nature of futures and the disincentives that it creates, high risk, margin calls, the threat of delivery, have succeeded in persuading the vast majority of American stockholders to stay out of the futures market. That may be in a practical sense the greatest suitability rule that one could possibly have.

We have not found any significant problem in the futures market and, if they appear, we will have to consider going beyond the steps we have already taken. But right now the futures market is—the composition of the population of the futures market is not the same. It appears to be more sophisticated and more affluent but as I say we will take a second look at that if we see any significant numbers of average investors coming in.

Senator LUGAR. Some State security authorities and Commissioner Stone recommended that the States be given authority to share in the regulation of commodity pools as they currently do in the area of mutual funds.

Could you comment on that recommendation?

Mr. JOHNSON. Yes, I would like to first point out that we have been for a number of months encouraging the States to get into the scam area. I cannot say that we have had great success in that area but we have had some.

We have published spotters guides to commodity fraud in all States and we have joined in a number of actions against the scams. We are 100 percent in favor of greater State role in that area.

The commodity pools, however, pose a slightly different situation. At the present time the commodity pools are regulated exclusively by the Commission and we have an extensive set of regulations governing their operations. These rules apply nationwide, no matter what State the pool is in. The pool will come to us and if it is a large pool it will go to the SEC as well to register. We do not think that there is a need to involve State regulators in the commodity pool area for two reasons.

The first is we feel that our own regulatory structure is comprehensive enough to protect the public.

The second is that the States have widely varying forms of regulation, particularly under their blue-sky laws, and this is particularly true of States that are referred to as merit States. In those States, they have broad discretion as to what we will or will not approve for sale to the residents of that State. While there are informal guidelines that the State securities administrators have developed among themselves, those guidelines, first of all, have never been sanctioned by the State legislature or by the Governor's office or by someone else. And, second, they are administered in a very unpredictable way.

We are very concerned that commodity pools will be required to walk around to the offices of each State security officer, because not only would it be a substantial expense to them, but the result would be extremely checkered in that a pool that has qualified with the Securities Exchange Commission and qualified with us, would wind up being disqualified in certain States, some States clearly do.

There are two States that have refused to register any commodity pool under any circumstances including pools that have been sponsored by the likes of Merrill Lynch, E. F. Hutton, and Bache.

Senator HAYAKAWA. If the Chair would excuse me, I have one question, perhaps a comment to make before I go to a Judiciary Committee meeting.

I understand that trading has been approved for stock index futures by the CFTC. This appears to be an instrument through which speculators on the stock market could hedge their bets on the futures market.

Mr. JOHNSON. That is right.

Senator HAYAKAWA. I do not understand the economic purpose of this contract. It is just one example of how futures trading is getting farther and farther away from the concerns of this Agriculture Committee. So long as we are dealing with agricultural commodities, I understand the relevance to this committee. But we stray farther and farther away when we get into the stock market, and stock index futures. We are thousands of miles away from agriculture.

I must say, Mr. Chairman, this disturbs me very much. Do you have a comment to make on this?

Mr. JOHNSON. Well, the premise of all these recent developments is that imitation is the most sincere form of flattery.

The agriculture community developed the hedging techniques and something like 100 years later, the economy woke up to these devices. I do not think that these developments in any sense jeopardize the utility of the agricultural market or the agricultural community. And the Commission does recognize and act in a manner to assure that the agricultural commodities are protected. We have not reoriented ourselves away from the agriculture area. We spend a substantial amount of our time in surveillance and other ways to insure that the agriculture——

Senator HAYAKAWA. I must say that I feel I would be more comfortable if these ventures which had nothing to do with agriculture were taken up by separate futures markets, independent of the commodities market. That is simply a comment that I wish to make.

I will excuse myself. Thank you very much.

Senator LUGAR. Thank you very much for coming.

Senator DOLE. I do not want to get away from the GAO report but since those matters have just been initiated at the Kansas City Board of Trade. What we are authorizing is, in effect, legalized gambling, and we are going to divert money from capital formation. It is fair to say that everybody on this committee probably has a special obligation to see what develops. I assume there are others who may, in addition to Kansas City, have an interest in this area.

Are you going to be watching it very closely as far as what is happening, who is investing, and if there is a diversion of funds from other areas?

Mr. **Johnson**. Yes, we are going to be watching that very closely.

I did get a report, Senator, yesterday from an official of one of the larger commodity firms who had had a trader on the floor in the Kansas City Board of Trade on the opening day who told me that two-thirds of the orders were hedge orders through his firm.

Senator **Dole**. We will have somebody here from the Kansas City Board of Trade later.

But in any event, you are aware of our interest and our concern. I supported the effort. I want to make certain that it works properly.

Mr. **Johnson**. Before we leave the subject, I would like to share a story with you.

Last summer at Senator Dole's kind invitation, I went to Salina, Kans., to speak to an agriculture group there and, when expecting to be asked a great many questions about low wheat prices, instead I was asked far more questions about how to use the interest rate futures market because of the high cost of borrowing in the agriculture community.

I wanted to relate that story because there are many ways, many instances, and many connections to agriculture in some of the other contracts that the Commission regulates.

Senator **Lugar**. This clearly has been a case also, one of my other responsibilities on the Banking Committee, where people have had a lot of trouble in savings and loans and banks have suddenly started discovering the futures market. If their management had been somewhat more alert earlier they would be in better shape. But it does lead to an interesting question on jurisdiction which Senator Hayakawa is raising. In a way I suppose that most of us on this committee felt that the futures process was the determinative aspect, although honest men may differ on it, but at least for the moment we are saddled with the responsibility to sort of plow ahead.

The GAO draft report states the Commission's rule, enforcement rules covered not all aspects of the exchanges and did not follow up on previous deficiencies. GAO recommends more enforcement reviews in the trading in a futures trade contract with the exchanges self-regulatory performance.

Could you comment on this finding and recommendation?

Mr. **Johnson**. Yes, I would have to return to some facts that I disclosed earlier.

We did an enforcement review, one in the New York market which was completed last summer and found that their system was highly deficient and as a result ordered them to revamp their program. And on top of that we fined them $200,000. The exchange at this moment is still on probation to determine whether they will carry out the changes that they have committed themselves to do.

Meanwhile, realizing that the GAO report is retrospective, we do have two enforcement reviews going on with the exchanges to determine whether they are up to snuff. We do conduct these, perhaps we could conduct them a little more frequently, although they are extremely time consuming, they are extremely resource intensive, but we are moving in that direction.

I hope within the next 6 weeks we will have new enforcement review reports on the markets that provide 80 percent of the trade.

Senator LUGAR. Let me turn now to another area, and that is approval of exchange rules and new contracts.

The Commission has not recommended any changes in its new contract designation authority. Yet some concern has been voiced over the long time which elapses between the time in which a new contract is posted and the time they are approved.

Do you believe it would be advisable to have a time cap on the contract approval process?

Now, I hear testimony, as I hear it this morning, you think that that would not be a good idea, but would you elaborate as to why that would not be a good idea?

Mr. JOHNSON. One of the things that I discovered since I came to the Commission is that a great deal of these problems can be resolved administratively. We tried in our legislative proposals to avoid attempting to cure by statute something that could be cured another way.

The second aspect of it is that we get contracts in now, and I think Senator Hayakawa's remarks are indicative of this point, that are brand new, that have never had any prior experience, that can be extremely complex, that can require us to reeducate some of our economists to learn about these areas.

We recently approved futures contracts in leaded and unleaded gasoline. Our economists had to learn a great deal about the energy area in order to assess these contracts.

We get contracts in from time to time that are incomplete. We get some in that simply are not sufficient for us to begin work on them. All of these imponderables make it impossible for us internally to project any specific deadline. We have had many instances where exchanges have come in with contracts, and after we put 6 months into them, they will call and say they changed their minds, they do not want it, or they want it completely revamped, and send it in as a new amendment or proposal.

I would not want to see us restricted in this area. I think the experience in the recent months of the Commission in handling contracts has been a successful one. I would not expect that that is going to change.

Senator LUGAR. Referring once again to Senator Hayakawa's question, you mentioned this new contract for leaded and nonleaded gasoline. What other mechanism conceivably could be appropriate for regulating that market? Granted that it is only marginally agriculture. Maybe nonagriculture at all, but you know, as we take a look at these alternatives, aside from not having such a contract, which I suppose is one way of dealing with it, if we are to have someone in our society, who else would handle it?

Mr. JOHNSON. I am not aware at this moment of any other agency that has the capacity or the skills to analyze a contract of this nature. As you indicated earlier, Mr. Chairman, the question of economic purpose and the analysis of contracts to determine whether or not they can be used for hedging or price discovery is a rather unique form of analysis within our Agency, and I am not aware that any other agency in the Government performs that function. Were another agency to be recreated, more likely they would hire away 50 percent of my staff, and I would not like to see CFTC under a different name.

Senator Lugar. Are you satisfied with the public interest in the standard for contract designations, rather than a more limited standard, for example, of hedging or risk management?

Mr. Johnson. The Commission prefers the public interest standard as it is at the present time. It is fundamentally nothing more.

We do, in fact, use the economic purpose test as part of the public interest test, but there may be certain instances, and I would be happy to supply examples for the record, of instances where it is necessary to go beyond the economic standards to determine whether there may be some effect that should be taken into account, even if it is not determinative, and we would want to have an opportunity to review these contracts as thoroughly as possible.[1]

Senator Lugar. GAO has recommended that the Commission charge exchanges a fee to review new futures contracts. What is your opinion of that recommendation?

Mr. Johnson. To my knowledge, the Commission would have no objection to doing that. It does not turn out to raise much money, frankly.

I think if we were to charge, let us say, $5,000 a contract, in some cases, like smaller exchanges, my people are reluctant even to charge that much. But if you were to charge that much, and assuming you got 20 new contracts in a year, it would be $100,000, which may be the cost of monitoring the fee system or might eat a good part of that. I am not sure that it is a very effective revenue source, but in principle, we certainly are not reticent of inaugurating a program like that.

Senator Lugar. You believe a 60-day time cap is sufficient for CFTC to determine whether it would approve or disapprove an exchange rule?

Mr. Johnson. In many instances, where the rule is a fairly simple one, 60 days is not only enough time, it is even more time than we need. We have been known to turn around rules in less than a week.

There are, however, some rules, such as major overhauls of the clearinghouse system, major changes in trading practices, where 60 days may not be sufficient time for us to be able to understand the full implications of what is being proposed.

So, for many of the same reasons that we are not supportive of a time limit on new contracts, we would not want to adhere to a 60-day limitation on these rules.

Senator Lugar. Would you comment on GAO's concern that, "the Commission continues to approve extension of trading before it more fully develops its monitoring and enforcement programs to protect the entirety of existing markets."

Mr. Johnson. What we attempt to do, and particularly with the explosive growth of the industry these days, is to attempt to be certain that all of the new offerings are of the same genre, if I can use that word, as those that have preceded it, is that the surveillance systems, the internal administrative procedures of the Commission can be used without major adjustments. Even in the options pilot program, we have designed it so that our existing surveillance and administrative regulatory capabilities could be used without redesigning the system.

---

[1] See p. 43.

I feel, and I think I could support this, that the Commission's oversight of these markets has been adequate. If we had a great deal more money I think we could probably enhance that, but there have been very few problems in the futures market recently.

Senator LUGAR. Let me ask some questions on the issue of speculative position limits. Where, during the so-called silver episode, did the Commission use the authority to set speculative limits, or why did it not do so, or how did this whole proposition of limits evolve during that period of time? [1]

Mr. JOHNSON. Well, once again, I was not present at the time of the silver situation. I will be happy to supplement the record as to the reasoning behind why nothing of that nature was done during that period.

Although I know that it was being monitored very closely during that period, the establishment of the new speculation provisions last summer was done because we thought that the silver episode had provided a lesson, and we were eager not to have another massive accumulation of positions by very wealthy speculators occurring in any of these markets.

Senator LUGAR. How would things work out in silver now? Perhaps an illustration. If I wanted to get in the silver market, what sort of limits would I have in getting into that market?

Mr. JOHNSON. I cannot give you an exact figure, because the submissions from the exchanges with silver markets are pending at our staff level, and I do not know exactly what the limits are. I think I can fairly and comfortably say it will be substantially lower than the types of positions that were held in the 1979–80 market.

Senator LUGAR. But the staff is still working in this now?

Mr. JOHNSON. Yes, the exchanges have submitted their rules for approval, and they are being processed by the staff.

Senator LUGAR. Do you think the law should be changed to permit CFTC to set limits on existing positions?

Mr. JOHNSON. We have the authority right now to set positions prospectively. To set position limits on existing positions presumably would only be significant if it were to force a reduction in the size of the existing positions.

The Commission does not support the idea of retroactive reduction in positions for fundamentally two reasons. The first is that it could have a massive impact on the markets as forced liquidations occur, causing prices to vary significantly.

The other is that with the speculative positions that we are going to be putting into effect, I do not think we are going to find ourselves with the situation of having speculators out there with enormous positions, and wondering how to get them to reduce them. The caps we are putting on should eliminate that problem.

Senator LUGAR. How soon will those caps be implemented? What timeframe are you looking at?

Mr. JOHNSON. I think within the next 30 days. We asked the Exchanges to submit their rules, we adopted the regulation in September, and we asked the exchanges to submit their rules, I think, in December. I think it was either December, or perhaps earlier, and they are under review now. I think within the next 30 days they will be finalized.

---

[1] See p. 44.

Senator LUGAR. Do you expect continuation of a situation which some futures markets have speculative positions set by CFTC, and others have limits set by the exchanges?

Mr. JOHNSON. We considered, when we were drafting our speculative position rules, whether to demand that the exchanges put speculative limits on those commodities where we already have Federal limits, and those are essentially the grains. We decided that we wanted to give more consideration to that, since these are extremely important commodities. These are areas in which we are very eager to be sure that adequate protection exists. So we have not relinquished our authority in that area, nor have we required the exchanges to set their own limits in those items.

Senator LUGAR. Let me turn now to the treatment of agents of futures commission merchants. The Commission's proposed legislation eliminates the category of agents of a futures commission merchant, and requires such persons who solicit or accept customary orders to register as associated persons of futures commission merchants.

The Commission would consider groups of such persons as a branch office for which the futures commission merchants have to assume responsibility.

At present, what types of persons, or firms fall into the agent category?

Mr. JOHNSON. Our statistics show that there are roughly 800 agents. About half of them are individuals. The other half, or most of the other half, tend to be quite small businesses, such as the local insurance agent who is getting futures business from some of his customers for transmittal to a brokerage house.

We know for a fact that there are agents, for example, in Florida, retirees, who together with their friends, phone in business to the brokerage house, and get a break on the commissions, as a result of this particular individual having introduced the business to the brokerage house.

We try to be sensitive that the fact that these are not big businesses, that they are people who probably could not afford to be hit with the full impact of any significant regulatory program. Instead, what we decided to do is to recommend that they be treated like an employee of the brokerage house. Therefore, the brokerage house would be responsible.

As I indicated in my opening remarks, we have problems with agents. Sometimes when you turn to the broker to solve a problem, they say that the agent is in business for himself, I do not have any control over him, I am not responsible.

Our objective here is to assure that that argument is no longer made.

Senator LUGAR. At present, who regulates the agents, and what is the nature of their regulation?

Mr. JOHNSON. At the present time the Commission regulates the agents in the category of associated person. But unattached to any futures commission merchant.

The result is that, unless we were prepared to do what we want the firms to do, which is mainly sit in on their activities, from day to day, we do not have an effective handle on how they operate. They are not subject, really, to supervision of any other company, and our capabilities certainly do not lend themselves to planting someone in each of their offices to be sure that they behave.

What we are doing here is attempting to get the FCM to take responsibility for the quality of the persons directing business to them.

Senator LUGAR. The industry has proposed that a new category of registrants be called an introducing broker. What is your comment on that idea?

Mr. JOHNSON. The motivation behind that, I believe—and I mean nothing pejorative by this—is to allow the FCM to avoid responsibility for the people who are directing business to it. A separate registration category would, in effect, permit the FCM to continue to say that they are not responsible for the person.

If that were the case, our only recourse, as we set up a new registration category, would be to put capital requirements on that agent, require them to file reports of this, to require them to keep records.

As I indicated earlier, these are not big companies. These are very small operations, and we are reluctant to impose a new burden upon people who cannot afford it, and would have to abandon that business totally, simply because they could not meet our requirements.

Senator LUGAR. How is the term "controlling person" defined? Controlling person in the sense that we are now talking about their responsibility.

Mr. JOHNSON. The controlling person concept is one that has existed in the securities laws since the thirties. I would like, if I may, Mr. Chairman, to provide a more scholarly definition than the one I am about to give.

But fundamentally, it is intended to reach those individuals within an organization who are in a position to control the company's policies, which for failure to adequately control could result in violations of the act.

I can give you some examples of situations where at the present time it is doubtful that these individuals could be reached. The act imposes a variety of statutory duties on the entity. The entity must be registered, the entity must have net capital of certain amounts, and the entity must segregate funds.

We do run into situations where a company has failed to register, or has become undercapitalized, or has failed to adhere to the customer segregation requirements, and it is all because of the fact that those within the management of the company have not either bothered to take an interest in this, or have consciously decided, in a sense, not to comply. It is difficult to pierce that corporate veil.

The officers say, listen, this duty does not run to me, it runs to the company. The company will pay a fine, and that will be it. We would like to reach some of these people. It is very difficult to do right now.

Even if we put the firm out of business, there is nothing precluding these individuals from setting up shop next door the following day, and behaving precisely the same way. So it has to do with this telescopic sight concept that I mentioned at the outset of my remarks. We need to be more precise.

Senator LUGAR. Would controlling persons be responsible under all circumstances for violations of the act, committed by those under their control?

Mr. JOHNSON. Well, I have heard it said that the chairman of American Express is worried these days that under this provision, that since the Shearson brokerage firm has been acquired by American Express, then if one of the Shearson salesmen were to misbehave, the chairman of American Express would be responsible. There is no merit to that.

The principal utility of the controlling person provision is in a small organization where the officers or directors, or in fact, the managers are responsible for the particular course of conduct under an act.

I think, as a general rule, we would look no higher in the organization than we had to to find people who should have maintained the proper business standards to avoid the violation as such.

Senator DOLE. Could I interrupt?

Senator LUGAR. Please do.

Senator DOLE. I would like to submit some questions in three areas.[1] One, in the reparations area, second, in the futures market by foreign entities, whether or not there is any impact, and what jurisdiction you have, and third, some additional questions on stock entities and futures contracts.

I have a staff member here, along with other committee staff, and if you cover those questions, we do not want to burden you with having to repeat answers. There are three areas that have been raised. Finally, and I do not mean to denigrate the efforts of the investigative committee, but I think it is fair to say that there is no way you are going to be able to protect everyone out there, particularly off-exchange areas. I do not see how you are going to be able to guarantee or provide protection for all consumers.

Mr. JOHNSON. It is impossible, Senator. The job is so large that I sometimes question whether the combined resources of the Justice Department, in the criminal prosecution area, can eradicate this problem, except over a period of years. But what frequently occurs is the fact that the word commodity is in our name, it allows people to point to the Commission, the Commission's presence, as an excuse not to act. That is the tragedy of it.

As I indicated, since this past fall, I have been doing a great deal to get the States more actively interested, and the results have been very mixed, indeed.

Senator DOLE. The larger problem is as you indicate, even though the great majority of the legitimate traders in the exchanges are men and women of integrity, you occasionally find someone off the exchange committing fraud. There is a tendency to highlight that as an example of fraud. An even larger problem is the impact reported frauds have on those who could or should legitimately use the exchanges, farmers in particular, who have their doubts and suspicions, when they see some 30 second or 1 minute news report.

---

[1] See p. 62 for questions submitted by Senator Dole and answers thereto.

Were there any legitimate areas covered by the Permanent Investigation Subcommittee, where the CFTC should have been able to provide protection, or detect the fraudulent activities carried on by, the three fraud defendants before the committee—Mr. Day, Mr. Wagner, and Mr. Levin—and did not?

Mr. **Johnson**. The interesting thing about the hearings, Senator, were that all of the witnesses, every single one of them, the swindler witnesses, had gone to jail as a result of the effort of the Commodity Futures Trading Commission. So I think we did our part in that area.

I think that some of the criticisms in the committee with respect to reparations program were on target. Hopefully, with the improvements that we are recommending to the Congress, we will be able to solve those problems. But it is frustrating indeed to be pointed at, an agency of our size devoting 20 percent of our enforcement budget to off-exchange areas.

Our statistics, and this is an estimate, because I do not quite remember them, are that the Commission has had 35 lawsuits against off-exchange people, 255 injunctions, the recapture of $3.5 million and 19 criminal convictions as a result of the efforts of the CFTC. That is on one side of the ledger.

On the other side of the ledger, with the exceptions of a few actions by the Attorney General and the States, it is virtually a goose egg. And the way the hearings were portrayed is that the Commission had failed.

So I think that in balance, although the committee provided an exceedingly valuable service in highlighting these problems, that the Commission's contribution was not as well highlighted until the final witness, of the final day, which was myself, testified, as it might have been in those proceedings——

Senator **Dole**. By then the cameras were gone, I assume?

Mr. **Johnson**. Yes, that is correct.

Senator **Dole**. Again, I am certain there is a legitimate purpose for the hearings by Senator Roth. Some of us, who live in farm areas, certainly want to ferret out fraud and deception, and do all the things that that committee has in mind against fraud. We do not want to set back some of the legitimate efforts of the CFTC or the exchanges. There is good progress being made with your leadership Chairman Johnson, and the leadership of other members of the Commission, and the oversight of this committee, under Senator Lugar, and others on the subcommittee.

So there has to be a balance in reporting fraud, but sometimes that is difficult, in a short 30 or 40 seconds, or a couple of minutes on the nightly news. All I saw were the swindlers and if that was all there was to that hearing, then I suggest there was not much balance.

Again, I understand the difficulty that the media has of trying to capsulize everything in a minute or two.

Senator **Lugar**. At least one good thing coming from the hearing is the desire by Senator Roth and Senator Rudd, who were principals, to work with this subcommittee and this full committee to implement suggestions that seem to be forthcoming from those hearings. I am grateful for their willingness to do that, and we have had personal conversation about that, as the result of the hearings.

I would like to also, at this point, submit on behalf of the chairman of our committee, Senator Helms, questions that he would like for you to answer, and I hope that you will do so.[1]

And likewise, Senator Helms has given to me, the staff has given to me on his behalf, a letter from Commissioner Stone, that he would like to have included in the record. So I will include that in the record, and make certain that it is complete.[1]

All right.

Now, I would like to turn now to the area of Federal control over commodity margins.

During the so-called silver crisis there were many suggestions to get the Federal Reserve, SEC authority to set futures margins.

What is the Commission's position on who should have the authority to set margins on futures contracts?

Mr. JOHNSON. The Commission's position is that the current margins system should continue, that the margins should be routinely set by the exchanges, and that the Commission should reserve the right to alter margins in emergencies.

Senator LUGAR. At present, who sets the margins on stock index futures contracts?

Mr. JOHNSON. The exchanges are doing that at this point. The Kansas City Board of Trade has set hedging and speculative margins.

Senator LUGAR. Now, that situation, I think arose, or at least it is reported to have arose in the press coverage from conversations that you and Paul Volcker, or other members of the Fed had last week, I guess, or sometime prior to that time.

What is likely to be the evolution of that situation? Is there going to be many press accounts, both of what occurred then, and what the Fed has thought subsequently?

For the record, how is the CFTC in communication with the Fed, or in what way is this likely to be resolved?

Mr. JOHNSON. I had a series of meetings with Chairman Volcker, prior to the Commission's meeting on the 16th, at which we took up the Kansas City Board of Trade proposal. As a result of those discussions, we were advised, on the morning of the hearing, that the Federal Reserve Board would not act at that time to impose margin requirements on the Kansas City contract, that it would, in all probability, and I understand, from this morning's press, that it has now sent out for public comments a request for views on the nature of the margin system, should the Fed ultimately determine to impose one.

I have the impression that that is a contingency plan, and I can only say that the Fed, having reviewed the Kansas City Board of Trade's adjustment in its margin levels, increased its margins, has taken no action at this point, and I cannot speak to whether they might at some point in the future.

I would say the situation right now is fluid. We are communicating with Chairman Volcker, regularly. We set up a joint monitoring program for the Kansas City contract, and all stock index futures contracts, so that the Fed will have an opportunity to follow the market and the developments that occur, and that monitoring system is now in place.

---

[1] See p. 66 for questions submitted by Senator Helms to Chairman Johnson and answers thereto, and p. 45 for the letter to Senator Helms from Commissioner Stone.

I would hope, without meaning to preempt the prerogatives of the Fed, in the final analysis, that no intervention in this area is necessary.

Senator LUGAR. Can you see an occasion when the CFTC would want to change an exchange futures margins, but would be unable to do so?

Mr. JOHNSON. I cannot, offhand, think of a situation of that nature. There could be problems that might arise in the market that fall short of a true market emergency, in which it might be our judgment that a proper response would be to change margins, and in all likelihood, we would jawbone the exchange to do so.

But if the market conditions reached the point that we felt they were in a crisis stage, then we do have the authority to step in.

Senator LUGAR. What effect does raising initial marging have on the liquidity of those margins?

Mr. JOHNSON. It is most difficult to say, because a high margin in a contract that is volatile creates two counterincentives. On the one hand the entry cost is high, on the other hand, the profit potential is high as well.

I do not know whether any studies have been done on the subject of correlating margin levels and market participation.

During the silver situation, margins went up to as high as $75,000 a contract, which is an unheard of level. Incidentally, I might point out that the exchanges did that voluntarily. I would assume if margin levels reach that point there are very few new people who are going to enter the market.

Senator LUGAR. Describe that for a moment, if you will. How could a single contract have a margin of $75,000? What is the arithmetic of that? If you were in the markets at that point, how would you go about transacting business?

Mr. JOHNSON. Well, I think that the $75,000 margin was an initial market on new trade.

Senator LUGAR. Per contract?

Mr. JOHNSON. Yes.

Senator LUGAR. How much would the size of the contracts have been in those days?

Mr. JOHNSON. It would have been 5,000 ounces of silver, at a price of, as high as——

Senator LUGAR. Fifty dollars?

Mr. JOHNSON. Fifty dollars. I think that is where it peaked out. So that would be $250,000.

Senator LUGAR. So that the $75,000 margin would be on at least, to use that extreme example, a contract worth $250,000, at that point?

Mr. JOHNSON. Yes.

Senator LUGAR. Thirty percent of the face value?

Mr. JOHNSON. Yes, that is correct.

Senator LUGAR. That would cover very adequately the current silver contract?

Mr. JOHNSON. Yes, it would.

Senator LUGAR. It would have a chilling effect?

Mr. JOHNSON. If those margin levels were in effect today there would be no silver trading at all.

Senator LUGAR. Now, do our futures markets change frequently? What has been your experience in the changing of these margin levels?

Mr. JOHNSON. Well, there are two aspects of that. One is the frequency of margin changes, and the second is the nature of it. It is an extremely complex equation.

Our estimate of 1981 was that futures margins were changed by the exchanges approximately 175 times.

Senator LUGAR. In what period of time?

Mr. JOHNSON. One year.

Senator LUGAR. One year?

Mr. JOHNSON. One year. Those changes can be designed to achieve a lot of different things. It can be intended to change margins only on the nearby delivery month, it can be designed only for spread contracts, or hedging contracts, or contracts which are speculative, and it can be piggybacked with other requirements or other restrictions that the exchange wants to impose.

So the 175 number, although it is a substantial number, only gives a very general idea of the complexity of the margin setting practice.

Senator LUGAR. Let me turn briefly to the State law enforcement area which you have discussed.

Next week, I understand that Senator Roth may introduce legislation that contains, first a provision similar to the Commission's disclosure of information of State law enforcement officials, and second, a provision giving individuals the private right of action under the Commodities Exchange Act, which is currently before the Supreme Court; and third, an expansion of State jurisdiction, probably greater than proposed by the Commission thus far.

And fourth, possibly the provision to give the State leverage over contracts. What are your initial thoughts about that legislation, or about those provisions, if in fact they are ones that Senator Roth incorporates?

Mr. JOHNSON. With respect to item No. 1, which I understand to be something very much akin to what we are proposing, I think that there is no question that we would be pleased to support that.

As far as private right of action is concerned, the Commission's position on that is that we favor a private right of action against those industry professionals who are found to have violated the substantive provisions of the act, such as having committed fraud, engaged in manipulation, conducted prearranged trading or matters of that nature, as well as against those persons who act in conspiracy to attain those ends. And those who aid and abet to achieve those ends.

We do draw a distinction in the case of self-regulatory organizations. Our view is against private rights of action as a rule in this instance, except where the exchange itself is engaged in the type of business misconduct that I described, or where the exchange's action is motivated by conflict of interest or self-dealing, rather than a conscientious attempt to do what is best for the market as a whole.

But to the extent that the exchange is charged with nothing more than having failed to be a superman, a perfect cop, where the only allegation is that the exchange has not been able to enforce its rules perfectly, as a regulator and enforcer ourselves, we sympathize with the fact that that type of objective is rarely, if ever met.

Senator LUGAR. Why have you recommended a recommendation of the CFTC's exclusive jurisdiction in the regulation of registered firms, such as commodity pool operators?

Mr. JOHNSON. Now, the reasons are twofold. First of all, there are roughly 800 commodity pools in the United States. We have had to take action against only roughly 1 percent of them for fraud. We do not think that the commodity pools in the United States, right now, although we keep a special eye on it, because they are a special type of entities, pose anything like the risk that the "scam" does. We think it is an area that we could gain sufficient control against the massive scandals.

Second, there is a uniform national and relatively efficient system of regulation in this area right now. Substituting 50 different sets of local standards which frequently conflict with one another, not to mention how they conflict with us, does not strike us as being an efficient use of any of those resources. And the standards are not even official in many States. The requirements change from day to day, depending upon the assessment of the particular individual. We do not think it is efficient, or that it makes any sense from a cost-benefit standpoint. We do not think it is in the best interest of this area, which is national, to require that 50 different stops be made, at different securities offices, frequently getting different answers to the same question.

Senator LUGAR. In the area of reparations and arbitrations, one of the major areas in which GAO found a new area for improvement was the reparations process. We touched on that this morning, but would you comment as to what extent the proposal is that you have met the recommendations at GAO, and has the Commission taken steps of the internal management of the program?

Mr. JOHNSON. Yes, we have taken a number of steps which we hope will help the problem. As I indicated in my remarks, that is not going to be enough. We are going to need to take a look at the program as a whole. The theory behind it, and the way it is structured generally.

We have, in recent months, and this began in Mr. Stone's administration, to try to streamline the reparations program. We have begun now to seek more administrative law judges, which has not been possible in recent months, because of budget constraints, and we have begun a computer tracking system so that accurate information will be available for new cases.

We have reorganized the Reparations Office for the purpose of consolidating all of what I will call the paper functions prior to hearing, and we have expedited that process, to some extent, just in the last year or so.

With respect to reparations, we have put out in the Federal Register a proposal which I think will, if adopted, encourage customers to use arbitration more than they do at the present time.

I will be happy to supply a copy of that for the record.

The fundamental nature of the proposed rule is to remind the customer, through our regulations, that arbitration is available as an alternative to reparations, and to indicate to him that he has the right to sign up for arbitration. If he does, he has the right to go there, and of course, if he does, he also is waiving the right to reparations.

I hope if that is adopted, that more customers will be aware of their alternatives.

Senator LUGAR. If the Commission decides legislative proposal is adopted, what recourse is there for a commodities customer who believes himself free, and by the way, who is not a commissioned registrant?

Mr. JOHNSON. Our decision to recommend to eliminate the nonregistrant is tied closely to a position of private rights of action. We feel that the private rights of action should be permitted so that the people can seek redress. To the extent that they have claims against nonregistrants, of course, the arbitration programs would be available to them, as well.

Senator LUGAR. How often do persons use the arbitration procedures now?

Mr. JOHNSON. Not as often as we would like to see. Customers do not utilize the exchange arbitration system very much. I wish they would do it more frequently.

Senator LUGAR. Do they use the reparations system very heavily?

Mr. JOHNSON. They do, indeed, and that is one of the problems, getting about 1,400 cases a year, while the exchanges are conducting far fewer customer arbitrations.

Senator LUGAR. On December 7, 1981, you and Chairman John Shad of the SEC came to an agreement on a range of issues that had been outstanding for many years, regarding SEC and CFTC.

What was the purpose of coming to that accord?

Mr. JOHNSON. The purpose was twofold. First of all, both Chairman Shad and I, with the full support of our respective Commissions, felt that it was time to move away from the competional situation that existed between the two agencies for nearly 8 years. It was imperative for both agencies to end the various fights over turfs, which was resulting in a number of new proposals being held hostage by the dispute, each agency fearing if it were to act, the other agency would attack it for doing so.

We decided if at all possible to resolve that problem. We initially agreed that we would not change the status quo with respect to anything being traded. We were not going to turn the clock back at all.

Second, we wanted to follow the theme that you, Mr. Chairman, have indicated, that there is a functional distinction between futures trading and securities investments. The agreement that was reached, I believe achieves that, by causing the Commission to retain exclusive jurisdiction over all futures trading, while leaving to the SEC the items like stock options and underlining securities trading, that is fundamentally within the SEC's background.

Senator LUGAR. There are several areas, such as futures contracts on municipal and corporate bonds, where trading is barred by the agreements.

Will you and Chairman Shad continue to discuss these and other areas on which agreement was not reached, and how many areas are there lying out there?

Mr. JOHNSON. To my knowledge, this is the only area in which there is a class of instruments in which agreement has not been reached. The desire of the CFTC to assure that it retains exclusive jurisdiction over all futures trading motivated it to argue in favor of having these particular instruments regulated by the Commission.

The SEC, on the other hand, took the position that these were coming terribly close to the trading of underlying securities, and this was something that the SEC should properly regulate.

We did not reach an accord on that issue, but agreed that we could continue to work toward one, and we will continue to do that.

Senator LUGAR. Let me just ask the question generally, about the cooperation of the CFTC and the SEC, or for that matter, to what extent do you, as CFTC, share market information surveillance data with SEC, the Treasury or the Federal Reserve, and do you work together with these agencies with regard to the violations?

Mr. JOHNSON. Particularly as a result of the experience in the silver situation, during which I should say a good deal of extensive liaison with other Federal agencies was developed, Commissioner Stone, when he was Chairman, took a very strong interest in the question of assuring that there would be improved coordination and liaison.

When I assumed the chairmanship, since then, I have been trying to build upon that base. The Office of Governmental Affairs of the Commission was reorganized somewhat to give it an agency liaison emphasis, and we have developed very close liaison with the Treasury Department, the Fed, the SEC, and we are developing one with the Energy Department now on gasoline and other things.

Of course, we have always had good liaison with the Agriculture Department, too. I have met on a number of occasions with the Chairman of the Fed and the Assistant Secretary of the Treasury, who is interested in this area, with Secretary Block and the Deputy Secretary, and others, and we try to get together no more often than we need to, because we all have things to do.

Following the hearings on Monday, in the House Agriculture Committee, in which the chairman of the subcommittee asked if the Commission would have any objection to admitting into the Commission's weekly market meetings representatives from the Treasury, SEC, and the Fed, just as we now invite a representative of the USDA, the Commission voted to adopt that procedure, and we will shortly be sending out invitations to those other agencies.

Senator LUGAR. Let me ask questions on agricultural options, or the lack of them.

Reauthorization legislation before us presently, the ban on agricultural options is continuing. Would you please outline the Commission's procedure to continue this prohibition?

Mr. JOHNSON. The Commission's position on agricultural options is that we have no objection to the removal of the ban. But we would be reluctant to support the idea, absent two preconditions. The first is that the Commission can put into place a proper regulatory structure to protect against the abuses that occurred back in the 1930's. And second, that there is a strong expression of interest in the agriculture community. That latter would be very critical to us in terms of determining whether these options would in fact have economic utility.

Senator LUGAR. In the House hearings, the American Farm Bureau Federation probably testified that they are likely to vote to support a pilot project. Of course, they are going to have a final board meeting on this in March.

But what sort of substantial support in the agricultural community would sort of qualify as the threshold for your coming interest in this?

Mr. JOHNSON. Well, an expression such as that would go a long way toward satisfying us that there is a strong agricultural interest in this. We do, at the same time, target specific firms that might be likely to use the options, and talk to them, or solicit their views on this subject.

Senator LUGAR. What have they said?

Mr. JOHNSON. Well, we have not done that yet. But that is a standard procedure.

Senator LUGAR. Has the regulatory framework of exchanges changed dramatically now, since 1936, when the ban first occurred, to properly oversee trading of agricultural options?

Mr. JOHNSON. I think the answer to that is yes. We would probably put agricultural options under a pilot program, as has been suggested, and it very likely would be similar to the options of the pilot program that we will be having in nonagricultural commodities. There we have not only folded into the program the existing exchange self-regulatory programs, but also have insisted upon certain new requirements of the exchanges.

We would probably attach those same requirements to an options pilot program in agricultural commodities.

Senator LUGAR. In your judgment, would options markets on agricultural products compete directly with the futures markets, or would they complement each other?

Mr. JOHNSON. I cannot give you an answer to that, Mr. Chairman. My economists may have an opinion on the subject, and I will be happy to supply their views for the record.[1]

Senator LUGAR. I would appreciate that.

Let me ask a question in the area of leverage contracts.

The Commission has proposed a statutory moratorium into the entry of firms and the leverage of business. Is there a moratorium on entry of firms into the business, and how long has this moratorium been in effect?

Mr. JOHNSON. There is a moratorium in place at the present time that we adopted in our regulations, and I believe it has been in effect since approximately 1978.

Senator LUGAR. How many firms are presently in the leverage contract business?

Mr. JOHNSON. A very, very small number of firms. There are probably no more than four that are active at this time. The great preponderance of the business is done by three.

---

[1] See p. 45.

Senator LUGAR. Now, my understanding is, from the hearings of Senator Roth's Permanent Subcommittee on Investigations, that since the inception of the reparations program, until December of 1981, four leverage firms ranked 6th, 10th, 11th, and 12th in the number of complaints filed with the Commission's reparation unit.

Why would there be such an instance of complaints, or proceedings in the reparations program zeroed in on these four firms?

Mr. JOHNSON. I do not have a direct answer to that. It is a fact that our reparations system is probably visited by complainants against leverage firms far more often than their number would seem to justify. It is a different type of instrument, however, and there were some rather serious gyrations in the value of precious metals over the last few years, which may have been a contributing factor, as well.

Senator LUGAR. Is the general philosophy of CFTC, with regard to the leverage firm situation, that you do not favor these kinds of proceedings, and grandfathered in four firms that were in the business, in the event, for some reason they said we are out of business, there will not any more?

Is this a situation in which the thing is sort of going to be dried up? How would you describe the lay of the land with regard to the leverage contract business?

Mr. JOHNSON. I am not aware that any firms have come to us and said please lift the moratorium, because we want in. I do not know that there are any more aspirants out there to enter this business.

I do have the impression that the firms that are in the business, or at least the most active ones, do have a thriving business, and that they are likely to continue to have that, depending upon the general economic and market conditions.

Our proposal to continue the moratorium for 2 years is really fundamentally so that we could take a look at the leverage business since 1982, which is, I am told, not identical to the leverage business of 1974, and make some hard judgments on the subject.

I, and two of my colleagues, do not have an adequate understanding of what the leverage business is today. I served on the advisory committee in 1976, that examined leverage programs, but I understand that they have changed a bit.

We are going to have to make some hard decisions in that area, and make them as expeditiously as possible. So we would like to conduct a 2-year study of the current operations of these leverage firms, and then present a report to the Congress. It would go beyond the questions that have arisen in the past, such as are these really futures contracts, and they would get into the policy issues of whether or not these operations are of sufficient national importance that they need to be regulated exclusively by us, or whether instead maybe there is a role for the States in this area.

We do not have the answers to those questions at this time, and we certainly would like to follow through on them.

Senator LUGAR. One final area.

Would you give a profile, if you can, of how big the entire industry is? We sort of touched upon this in various ways. We discussed 100 million contracts in 1981, volume on the various exchanges that you are regulating.

You testified in an extreme way describing one of those contracts in the case of the silver markets is worth $250,000, it would be worth now more like $40,000, $45,000, so we have extreme range between those values.

But how big a business is this in America right now?

Mr. JOHNSON. The 100 million volume figure is reasonably accurate. I think it is 98, really.

Senator LUGAR. Contracts?

Mr. JOHNSON. Futures contracts, that is right. Occasionally one sees an aggregate dollar figure as to the value of all futures contracts combined, and that figure is somewhere, I believe, between $2 trillion and $3 trillion.

Senator LUGAR. In a single year's time?

Mr. JOHNSON. Yes, that is right. That is not in fact how much money changes hands, but it is the aggregate value of all contracts.

The commission income to the brokerage community, I am told, is up in the hundreds of millions. It may not be as high as $1 billion. Hundreds of millions would probably be more like it.

The margin deposits that find their way into the banking system earn interest, and, if one assumes that on every futures contract there is a margin deposited somewhere, perhaps 5 percent of the value of the contract, it is some indication of the flow of money through the banking system, and through the economy. It is a very substantial amount of money involved here, and in an industry with 11 exchanges, and fewer than 400 brokerage firms, it is a major part of the economy today.

Senator LUGAR. I deeply appreciate your testimony. You have been most patient, as the Chair has tediously proceeded after one issue area after another, and these are, by no means, I am sure, an exhaustive list, but I felt they were important ones, which the testimony that you could give us was very valuable to us.

As you know, we will be proceeding now through 4 more days of hearings. Next Monday and Tuesday we will have hearings in which a number of distinguished members of the industry will be coming to the subcommittee. I know that you will follow these closely. Those hearings, we may want to call upon you at some point for comment, but I simply express my personal appreciation to you and the members of the committee who were here today with us, and those who were not. We will try to keep them informed.

Thank you for coming.

Mr. JOHNSON. Thank you, Mr. Chairman.

[Whereupon, at 12 p.m., the subcommittee recessed, to reconvene at 9:30 a.m., Monday, March 1, 1982, in room 324, Russell Senate Office Building.]

[The following was received in response to questions asked Mr. Johnson during the hearing:]

COMMODITY FUTURES TRADING COMMISSION,
Washington, D.C., May 5, 1982.

Hon. RICHARD G. LUGAR,
Dirksen Building,
Washington, D.C.

DEAR SENATOR LUGAR: During the hearing before your Subcommittee on February 26, 1982, the Commission requested permission to supplement the record in response to certain questions. The following is submitted in accordance with that request:

Question. Why did the Commission not use its emergency powers during the so-called silver crisis a year or two ago?

Answer. At the Hearing, I indicated that I would supply the answer to this question after consulting Commission records and recollections, since I was not with the Commission at this time. The answer may shed light on both the silver situation as a historical matter and the CFTC's attitude during that period toward the use of its most extreme statutory power. The declaration of an emergency during late 1979—early 1980 would not have served the public well. The Commission felt that use of that provision in the circumstance might have forced the CFTC into a role involving prolonged direction and supervision of market operations, for which no agency of government is well suited. There was, in addition, a substantial concern that taking emergency action in the futures market at that time and under prevailing conditions might itself have been a disruptive force in the larger, worldwide cash market.

In view of these concerns the Commission exercised its judgment not to directly intervene in the market, but rather to prod action from the Exchange's self regulators, who were close to the situation and possessed the necessary effective remedial tools. Due in part to the Commission's concerns, the two major Exchanges fashioned on their own initiative numerous actions including frequent adjustment of margin requirements on futures positions and the imposition of liquidation-only trading orders in late January 1980. In combination, these actions substantially alleviated the perceived problems while maintaining the financial integrity of the silver market.

Commodity futures exchanges have acted as self regulators for well over a century. Since 1922 government as well has exercised regulatory authority, primarily by providing oversight of exchange self-regulation. When, in 1974, Congress provided the Commission with additional and more powerful regulatory tools than its predecessor agency had possessed, including emergency action authority, self-regulation was maintained as the first line of defense. The terms of the Act and the limited resources allotted the Commission make clear that initial responsibility for the operation of the futures markets is left to the private sector and its self-regulators. The Commission plays an important oversight role and may directly intercede when in the Commission's judgment it is warranted to do so. Emergency powers are the strongest tool in such circumstances and thus they are our tool of last resort. The Commission has always considered effective and timely exchange actions as preferable to governmental intervention.

The Act provides for application of the Commission's emergency powers when the Commission has reason to believe that there exist "threatened or actual market manipulations and corners" or when there has occurred an "act of the United States or a foreign government affecting a commodity or any other major market disturbance which prevents the market from accurately reflecting the forces of supply and demand for such commodity..." In the fall of 1979, early in the period in question, there was no reason to believe at the time that any of these conditions existed. Published reports and Congressional testimony on the silver episode have stated that the actions of the major holders of long positions were at variance with conduct normally witnessed during a market squeeze in a maturing futures contract. It has been pointed out that the largest position concentrations were in the deferred rather than in the nearby months; some of the large longs were willing to accept non-certified silver in other locations and forms in lieu of strict contract compliance; the largest longs had offered assurance that they would liquidate or roll forward at least part of their positions in the maturing futures contracts; and futures prices and U.S. and world cash prices did not deviate to any significant degree. (CFTC Report to Congress Pursuant to Section 21 of the CEA at 26). There were no forces beyond the cash and futures marketplace and their participants causing a disturbance which prevented the silver market from reflecting supply and demand. Finally, there was no known government action which had affected silver prices.

The Commission has been extremely cautious in the exercise of its emergency powers and is mindful of Congressional direction to use these powers only when the Commission believes it absolutely essential. In the four years of Commission operation prior to late 1979, the Commission had exercised its emergency powers only three times: once with respect to the New York Mercantile Exchange's November 1976 potato contract; once with respect to the New York Coffee and Sugar Exchange's December 1977 coffee contract; and once with respect to the Chicago Board of Trade's March 1979 wheat contract. Each of these Commission emergency orders was aimed at remedying an acute problem of trading congestion in an expiring futures contract. These very short term emergencies involved only the last few days or weeks of trading and they required specific and limited remedial action. Understanding the nature of the Commission's emergency power, the single Court of Appeals to have ruled on its use noted that it was established by Congress to permit "swift and effective action" in those situations which "occur suddenly . . . (in) the volatile futures markets . . ." *The Board of Trade of the City of Chicago* v. *CFTC*, 605 F.2d 1016, 1023 (7th Cir. 1979). Longer term and more pervasive problems generally are appropriately addressed by other means.

In the silver markets, the Commission believed that any decision to intervene early in the period of concern might have forced the CFTC to attempt to administer prices or the operations of the markets over a prolonged period. The declaration of an emergency would not, of course, have been a solution in itself. The congestion of large silver futures positions extended over several cash and futures markets and many delivery months. No single Commission order, or even any short series of orders, would have been adequate. A complex array of market actions regarding margin levels, trading and position limits, and possibly the liquidation of existing positions would have been required. The exchanges, moreover, began to take action in the fall of 1979, and had adopted all of these measures in some form by late January 1980.

Even with the benefit of hindsight, neither the Commission nor anyone else has identified with any confidence a course of action sounder than that chosen by the Commission based on what was known about the circumstances prevailing during the silver episode. Those events have been and will continue to be studied by the Commission, of course.

Question. Are you satisfied with the "public interest" in the standard for contract designations, rather than a more limited standard, for example, of hedging or risk management?

Answer. The Commission prefers to retain the public interest standard as it is at the present time. We do, in fact, apply the public interest standard in reviewing applications for contract market designation, yet there are certain instances where it becomes necessary to go beyond this standard and examine other effects of the proposed contract.

Consistent with section 5(g) of the Commodity Exchange Act and with interpretations of the meaning of the public interest standard provided by members of Congress at the time this amendment was added to the Act in 1974, the Commission requires that boards of trade submit evidence in support of the economic utility and other aspects pertinent to the public interest associated with contracts proposed for designation. As explicitly defined in the Commission's Public Interest-Guideline No. 1, this evidence must be sufficient to show that the contract is not contrary to the public interest; i.e., satisfy an economic purpose test. This test requires that the evidence show that the prices of the contracts are, or can reasonably be expected to be, used as a basis for determining prices to producers, merchants or consumers; or that the contracts are, or can reasonably be expected to be, used by producers, merchants or consumers for hedging purposes.

The Commmission's recent consideration of the Value Line and Standard and Poor's Stock Index futures contracts as well as Eurodollar contracts provide illustrative examples of situations where factors other than the economic purpose test were evaluated during the designation process. With regard to the stock-index futures, a number of concerns were raised by various federal agencies involved in the regulation of securities and financial markets. These concerns included: the adequacy of customer suitability and protection standards; the effect of different margin requirements between the stock-index futures and the underlying securities markets; the potential effects of these futures markets on the capital formation process; the impact of trading in these contracts on the ability of the Securities and Exchange Commission to conduct its surveillance and oversight responsibilities in the underlying securities markets; and the ability of the Commission as well as the exchanges to adequately surveil a potentially large number of stock-index futures. The Commission explicitly considered these concerns as part of its designation deliberations.

As an additional example, the Commission evaluated the potential implications of Eurodollar futures trading for the conduct of national monetary policy during this contract's designation process. This consideration stemmed from concern expressed by the Federal Reserve Board that trading in Eurodollar futures might encourage greater participation in the underlying Eurodollar market and potentially affect the Board's control of monetary aggregates. The Commission acted on these contract proposals after study of the Board's concerns.

Question. Let me ask some questions on the issue of speculative position limits. Where, during the so-called silver episode, did the Commission use the authority to set speculative limits, or why did it not do so, or how did this whole proposition of limits evolve during that period of time?

Answer. The major considerations that prompted the Commission at that time to encourage responsible self-regulatory action rather than to impose speculative position limits were statutory. At that time, neither the Commission nor the exchanges had established speculative position limits for silver futures. Though the Commodity Exchange Act clearly provides for Commission imposition of speculative limits on new positions, Section 4a(2)(B) states "that such position limits shall not apply to a position acquired in good faith prior to the effective date of such order." During the silver episode, exchanges had silver futures contracts listed up to 18 months out. Thus, Commission imposed limits under Section 4a would not have affected the huge silver futures positions held by the largest speculators in the nearby months nor those positions held in contracts which extended into 1982. Yet, while the Commission was barred from imposing such retroactive position limits, the exchanges faced no such bar.

A secondary statutory restriction also limited the Commission's options. Section 4a(1) of the Act prohibits the Commission from imposing limits without "due notice and opportunity for hearing." This process involves the development of a staff proposal, initial Commission adoption of such a proposal, a public comment period based on publication of the proposal in the Federal Register and final Commission adoption of the proposal. Because of the increasing volatility of the silver markets, the Commission chose to forego this time consuming and laborious procedure. Similar time consuming procedures would have been involved had the Commission utilized Section 8a(7) of the Act to request, and if necessary adopt, changes in the exchanges' rules regarding these limits. Instead, it was the consensus of the Commission to encourage less disruptive and time consuming yet more effective self-regulatory exchange action.

This strategy was discussed at numerous non-public meetings of the Commission during the early Fall of 1979 and repeatedly urged upon exchange leaders. In October 1979, the Commission scheduled a public meeting on the subject of position limits in precious metals. Almost simultaneously, the Chicago Board of Trade announced imposition of speculative position limits in silver. New York's Comex followed suit in early January. Thus, the exchanges did act, imposing limits much sooner than the Commission might have done. The exchanges' retroactive limits also applied to the largest speculators. The Commission's Section 21 report on silver futures concludes that the exchange's action "led to reduced concentrations in nearby futures contracts and mitigated the threat of a successful silver market corner or squeeze by preventing any additional accumulation of large long positions once the position limits were in effect." (See Report to the Congress in Response to Section 21 of the Commodity Exchange Act, page 15.)

In the aftermath of the silver crisis, the Commission began serious consideration of a number of regulatory changes designed to prevent a recurrence in silver or other commodities. The advisability of permanent speculative position limits in all commodities was among the most important to be taken up.

The Commission's Section 21 Report concludes that "reasonable limits in place before the buildup of large (silver futures) positions occurred, would have helped prevent the accumulation of such large positions and the resultant dislocations created when the holders of these positions stood for delivery." (Section 21 Report, page 173) It goes on to observe that "it seems clear from the silver crisis that the orderly imposition of speculative limits before a crisis develops is one of the more promising means of solving such difficulties in the future." (Section 21 Report, page 175)

With this in mind, the Commission adopted in October 1981 a rule which ensures that each futures and options contract traded on a designated contract market will be subject to speculative position limits. The rule requires exchanges to adopt and submit for Commission approval, speculative position limits in active futures markets for which no exchange or Commission imposed limits are in effect. As the Federal Register notification of the rule's adoption notes, "imposing position limits on individual contracts is to prevent unreasonable fluctuations or unwarranted changes in the price of a commodity which may occur by allowing any one trader or group of traders acting in concert to hold extraordinarily large futures positions." (46 FR 50938, October 16, 1981)

Commission adoption of its speculative position limit rule will help to prevent or mitigate a recurrence of a similar crisis at some future date. Whether earlier adoption by the Commission of such a rule would have prevented the silver crisis is a matter of judgment. While the Commission study suggests that it might have, it is clear that Commission imposition of such limits would have had to occur very early, probably 1977 or earlier, since the largest of the speculators had established and continued to hold large silver positions for several years, rolling them forward.

Question. In your judgment, would options markets on agricultural products compete directly with the futures markets or would they complement each other?

Answer. In absence of actual experience with the trading of options on agricultural commodities, it is difficult to predict precisely the net effects of option trading on the performance of related futures markets. However, it does seem clear that options on agricultural commodities would give agricultural producers, merchants and other cash market participants an additional avenue for reducing risks stemming from the inherent price instability of many agricultural commodities. Secondly, options differ significantly from futures in terms of their risk transfer characteristics. In particular they offer a limited risk instrument whereby the buyer could profit from a move in price in one direction while limiting risk of a price move in the opposite direction. The seller can lock in a price, at the same time collecting an option premium. However, futures may offer a better mechanism for risk shifting to dealers. This suggests that options will complement and not adversely affect their associated futures markets. In addition, given the potential for arbitrage trading activity between options and futures, the availability of option markets may indeed increase trading activity in agricultural futures markets.

Despite the lack of experience with concurrent trading in option and futures markets for the same commodity, some experience is available from securities markets where option markets exist for selected securities traded on major stock exchanges. Although definitive studies have yet to be performed concerning the effect of options markets on trading in underlying securities, the existence of negative impacts on those asset markets is not readily discernible. Also, the Chicago Board of Options Exchange in a recent Securities Week publication has estimated that the availability of options markets may increase the volume of trading activity in the underlying security by as much as twenty percent. However, it is unclear to what extent securities market experience can be extrapolated to futures markets since fundamental differences exists in terms of the instruments traded as well as the underlying purposes for participation in these markets.

On page number 87 of the Subcommittee hearing transcript, reference is made to a Commission proposal published in the Federal Register which should encourage use of arbitration by customers. A copy of that publication is attached with this letter.

Sincerely,

PHILIP MCBRIDE JOHNSON, *Chairman.*

[The following letter was submitted for the record by Senator Helms:]

COMMODITY FUTURES TRADING COMMISSION,
Washington, D.C., February 23, 1982.

Hon. JESSE HELMS,
Chairman, Committee on Agriculture, Nutrition, and Forestry, U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: In connection with its 1982 reauthorization hearings, the Commodity Futures Trading Commission has recently submitted to the Congress a proposal seeking a number of amendments to its enabling legislation.[1] The major elements of the Commission's proposal, a product of extensive work and deliberation, are highly constructive and worthy of your support. During my term as Commission Chairman and member, however, I have come to believe that more significant statutory changes may be called for than those supported by my colleagues.

The commodities industry is in a period of extremely rapid evolution. As recently as ten years ago, the futures markets were limited almost exclusively to their role in the marketing system for agricultural products. Trading was the business of sophisticated commercial groups and a small number of affluent and knowledgeable speculators.[2] During this agricultural phase of futures market history, trading was appropriately regulated within the Department of Agriculture.[3] The regulatory authorities concerned themselves primarily with contract terms, delivery points and other mechanisms for assuring honest and competitive agricultural prices. It was with the designation in 1975 of the first futures contracts on interest rates that the current period of unprecedented growth and structural change in the futures industry began.[4]

---

[1] The Commodity Exchange Act, as amended, 7 U.S.C. §§ 1 et. seq. (1976 and Supp. III 1979). It will be referred to in this letter as the Commodity Exchange Act or, simply, the Act.

Congress had correctly perceived the onset of this new phase in 1974, and had transferred the regulatory responsibilities for futures markets from the Agriculture Department to a new independent agency. The establishment of the CFTC, with its broad mandate to approve economically useful futures contracts in virtually any good, article, right or interest, provided an environment of regulatory flexibility in which the industry's expansion could occur.[5] There were only 12.4 million futures contracts traded in 1970; ninety percent of these were in agricultural commodities.[6] By 1981, the annual volume had reached 101 million contracts, an eightfold increase.[7] The single most active contract traded was the Chicago Board of Trade's Treasury Bond contract, and approximately half the 1981 industry-wide volume was in contracts for non-agricultural commodities. The financial futures volume alone was almost double the industry's entire volume just a decade earlier.[8]

The growth of volume reflects more than a heightened level of commercial and floor activity. Innovative futures contracts have demonstrated a powerful appeal to public customers. Large numbers of non-professional speculators, some financially sophisticated and some less so, have been added to the ranks of futures customers. The total is usually estimated to be in the hundreds of thousands, and commission volume is said to have exceeded a billion dollars annually.[9]

Throughout the period of financial futures development, the commodities industry has taken pains to distinguish itself from the securities industry. Commodities spokesmen have been quoted often on the differences between securities investors and commodity speculators. The customer protection rules of the Securities and Exchange Commission have been commonly characterized as stifling, rigid, and too paternalistic to be applied to the futures world.[10] The CFTC, by and large, has shared this view, and it has gone its own way in formulating a regulatory framework for commodities.[11] If the long and stable first phase of industry development can be called the agricultural phase, the second must be the independence phase.

---

[2] The distinction between commodities and securities customers was described in 1973 by W. R. Poage, then Chairman of the House of Representatives Committee on Agriculture as follows:

"Securities markets attract the small speculator, with a limited exposure to loss, futures speculation is normally limited to the more venturesome and solvent speculator." 119 Cong. Rec. 41, 335 (1973).

Also See Johnson, P., "Commodity Futures Trading Commission Act; Preemption as Public Policy", 29 Vanderbilt Law Review 1, 23 (1976); and Johnson, P., "The Perimeters of Regulatory Jurisdiction Under the Commodity Futures Trading Commission Act", 25 Drake Law Review 61, 62-5, (1975).

[3] Regulatory Authority was provided to the Secretary of Agriculture by the 1922 Grain Futures Act, Ch. 329, 42 Stat. 998. It was later delegated to the Commodity Exchange Authority within the Department of Agriculture.

[4] The Commission designated the Chicago Board of Trade as a contract market in mortgage certificates guaranteed by the Government National Mortgage Association on September 11, 1975. A contract on 90-day Treasury Bills was approved for the Chicago Mercantile Exchange shortly thereafter.

[5] Section 2(a)(1) of the Act defines commodities over which the Commission has exclusive jurisdiction to include those specified and predominantly agricultural products in which there was futures trading prior to 1974 "and all other goods and articles, except onions . . ., and all services, rights and interests in which contracts for future delivery are presently or in the future dealt in . . . ."

[6] Source: Commodity Futures Trading Commission Annual Report 1981, p. 126.

[7] Ibid.

[8] There were 11,973,459 U.S. Treasury Bond contracts traded on the Chicago Board of Trade in the fiscal year ending September 30, 1981, each with a face value of $100,000. On November 25, 1981, the CBOT's T-Bond contract set a record for the highest volume in a futures contract in a single day, with over 131,000 contracts traded. Financial futures trading in fiscal year 1981 accounted for 19.8 percent of total futures volume. Source: CFTC Annual Report, Op. Cit., and "Comment on Futures", a newsletter published by Donaldson, Lufkin, Jenrette, Inc. (January 22, 1982).

[9] There is no official record of the number of futures market customers. Industry officials have been quoted as putting the figure in the hundreds of thousands. See "Questions on SEC-CFTC pact linger," Chicago Sun-Times, December 30, 1981.

One might verify that estimate by analogy to the securities industry. According to a 1980 New York Stock Exchange study, there are 6,209,000 active accounts held by brokerage firms. The accounts were handled by 200,000 registered representatives according to records of the National Association of Securities Dealers. There are approximately forty-five thousand associated persons presently registered with the Commission. If each registered Associated Person handled half as many accounts as the average registered representative, the number of futures market participants at any one time would have to be in the neighborhood of 683,000. If each Associated Person handled only one-third as many accounts, the number would be approximately 454,000.

According to David Johnston, Senior Vice President of E. F. Hutton & Co., gross commissions for U.S. futures exceeded one billion dollars in 1979 and were more than ten times greater than gross commissions in 1970, Commodity News Service, March 5, 1980.

There are unmistakable signs today that a third phase is dawning. In the last few years, the distinctions between securities and commodities have rapidly eroded. The largest commission firms in commodities are not specialty houses; they are affiliates of the major securities firms.[12] Commodities customers and securities customers are increasingly drawn from the same lists. Three of the oldest and largest commodity houses have recently merged with securities giants.[13] The Chicago Board of Trade, which had cut all ties to its offspring, the Chicago Board Options Exchange, during the independence phase, is now talking of a reassociation.[14] The New York Stock Exchange created its own commodities affiliate and then negotiated a cooperation agreement with the Chicago Board of Trade.[15] I would feel safe in predicting that other commodities and securities exchanges will soon follow suit with their own affiliations or mergers. The approval by the CFTC just last week of an application to trade futures on a common stock index is a final proof that the lines have been blurred.[16] The independence phase is quickly giving way to the merger phase.

Should this trend continue, the arguments for maintaining two separate regulatory agencies, and two distinct philosophies, will dissolve. If the industries become one, the CFTC and the SEC should consolidate as well. The 1982 reauthorization hearings, of course, need not be the forum for considering this combination. They can as easily be viewed to be the last hearings of the independence phase as the first hearings of the merger phase. My recommendations are premised on the assumption that the CFTC will survive the hearings as an independent agency.

The changing industry structure in itself provides guidance on one reauthorization issue. There is no reason to believe that the futures industry a few years from now will look any more like the futures industry of today than today's industry looks like the industry of 1978. Congress acted judiciously in establishing four year reauthorization cycles in 1974 and again in 1978. With industry fundamentals in a state of obvious flux, the period of reauthorization should be similarly short in this cycle.

The following comments on the substance of reauthorization go to numerous areas of the Act. On most of these, I have testified or written at length in connection with previous Congressional proceedings. Where this is the case, I have tried to summarize rather than repeat a lengthy presentation.

---

[10] *See* Record of CFTC Open Meetings and public comment letters with respect to staff proposals for the commodity option pilot program, 1979 and 1980.

[11] In fashioning its anti-fraud rules, for example, the Commission determined not to track the anti-fraud provisions of SEC Rule 10b-5, 17 CFR 240.10b-5, out of concern that such "might invite an uncritical application of securities law principles and practices" to what it viewed as the distinct area of commodities. 40 Fed. Reg. 26504 Commodity Futures Law Reporter (1975-7 Transfer Binder) (CCH) Paragraph 20,049.

[12] According to sources in the CFTC's Divisions of Trading and Markets, the largest securities firm, Merrill, Lynch, is also the largest producer of commodities business with over $160 million in commissions on futures during fiscal 1980. At least six other major broker-dealer firms are among the top commodities commission producers as well, with fiscal 1980 commissions in excess of $25 million each.

[13] During the fall of 1981, the commodities firm of J. Aron & Co. was acquired by Goldman Sachs & Co. and ACLI Commodities merged into Donaldson, Lufkin & Jenrette. Phibro and Solomon Brothers consolidated in October of 1981 to create one of the largest diversified commodities and securities houses.

[14] See Chicago Board of Trade press release "CBT-CBOE Joint Trading Venture", December 2, 1981.

[15] The CFTC designated the New York Futures Exchange on May 28, 1980, as a contract market for five currencies, and on July 15, 1980 as a contract market in 90-Day Treasury Bills and 20-Year Treasury Bonds. The New York Futures Exchange, an affiliate of the New York Stock Exchange, opened trading on August 7, 1980. Its proposed link to the Chicago Board of Trade was announced the following year. See Chicago Board of Trade press release "CBT members vote to establish CBT/NYFE Link", December 14, 1981.

[16] On February 16, 1982, the CFTC designated the Kansas City Board of Trade as a contract market to trade futures contracts based on the Value Line Average, an index of common stocks. See CFTC press release No. 885-82, February 16, 1982.

The issue on which I have testified most frequently is the need for a government presence in the fixing of futures margins.[17] The 1929 stock market crash plainly demonstrated to the American people and the Congress that there is a public interest in the level of securities margins. The same public interest is present in futures margining, and I surely hope it will not require a genuine crisis to illustrate this point.[18] While it is frequently observed that securities margining takes the legal form of an extension of credit while commodities margining does not, this difference has little to do with the issue at hand. Margins in both cases function as a threshold for the new customer. Decisions by most customers on whether to enter a market and decisions on how large a position to take are inevitably influenced by a comparison of the customer's available cash and the amount of margin required. Margins in both commodities and securities also play a role in the exit of traders from a market. The lower the initial margins, the greater is the chance that traders' positions will have to be liquidated against their will.

By drawing undercapitalized and uninformed speculators into a market, low margins may reduce the average level of fundamental price sophistication. By magnifying the capital of large speculators, low margins tend to amplify the risks of market domination by oversized position holders. Perhaps most important, low margins can cause personal cash flow consideration—of traders both small and large—to be substituted for fundamental market judgment in times of rapid price movement. The snowballing of margin calls can turn a routine price adjustment into an exaggerated swing or a larger correction into a panic.

The exchange governing boards are well equipped to adjust margin levels in order to protect the solvency of their members. They are not constituted to take account of broader economic issues in their decisionmaking. I would strongly recommend that Congress vest in either the CFTC or the Federal Reserve Board of Governors the duty to establish and adjust, as required, minimun levels of permissible margins for each futures contract. A minimum level established in this manner would serve as a floor below which exchange margins could not be reduced but above which the exchanges would retain their present flexibility and authority.

Even if exclusive exchange authority over margin levels is maintained, a number of incremental improvements are worthy of Congressional consideration. Few events in the commodities world would be as disastrous as the failure of the clearinghouse. Recent events have reduced the level of comfort in the industry with respect to the invulnerability of the clearing system.[19] In the long run, I suspect that the public and the business community would be best protected by the formation of a unified, industry-wide clearing mechanism, protected against default by a federally chartered guarantee fund. In the short run, I would recommend two changes in the prevailing rules.[20]

---

[17] My views on the subject of commodity margins are set forth in greater detail in my testimony of May 1, 1980 before the Subcommittee on Agricultural Research and General Legislation of the Senate Committee on Agriculture, Nutrition, and Forestry; in testimony of May 21, 1980 before the Subcommittee on Conservation and Credit of the House Agricultural Committee; in testimony of May 29, 1980 before the Senate Committee on Banking, Housing, and Urban Affairs; and also in "Additional Comments on the Interagency Study of Silver Markets," prepared in connection with Section 21 of the Commodity Exchange Act, Pub. L. No. 96-276, 96th Cong. 2d Sess., Section 7, 94 Stat. 542 (June 1, 1980), and presented to the Subcommittee on Conservation, Credit and Rural Development of the House Agriculture Committee in connection with hearings on October 1, 1981.

[18] President Roosevelt in a March 26, 1934, submission to Congress proposed higher margins to restrict both securities and commodities speculation. He stated:

"The people of this country are, in overwhelming majority, fully aware of the fact that unregulated speculation in securities and in commodities was one of the most important contributing factors in the artificial and unwarranted 'boom' which had so much to do with the terrible conditions of the years following 1929.

"I have been definitely committed to definite regulation of exchanges which deal in securities and commodities. In my message I stated, 'It should be our national policy to restrict, as far as possible, the use of these exchanges for purely speculative operations.'"

Congress accepted President Roosevelt's recommendation with respect to securities margins but did not act to provide regulation of commodities margins. See Public Papers and Addresses of President Roosevelt, Vol. 3, Document 52, page 170, Random House (1938).

[19] After the events in the silver market during March of 1980, one prominent attorney who had represented a large clearing member of Comex commented that, "Clearing associations will not cover a default if it means committing economic suicide. When those who are in the good to the last drop (clearing) system are called for huge amounts of money in the event of a cataclysmic default, you can be certain they will call their lawyers and not their bankers." Source: The New York Times, April 13, 1981. Subsequently, the Commodity Exchange Inc., and the Coffee, Sugar and Cocoa Exchanges amended their rules to create or strengthen clearinghouse guarantee funds. 46 Fed. Reg. 15192, 27366 (1981).

Most clearinghouses today collect initial margins from member firms only on a net basis. A firm holding positions totaling ten thousand contracts on the long side of the market and ten thousand and one contracts on the short side is obligated to deposit the required margin for only one contract. This effectively makes each member firm a mini-clearinghouse, and it places too much dependence on the wisdom and good faith of a diverse population of members. In a crisis, this arrangement can precipitate a race by rival clearing organizations to see which one can first lay claim to a threatened member's assets. A statutory requirement that margins be collected on gross position sizes rather than the net balance would help assure the integrity of the clearing process.

The probability that any individual trader can injure the clearing system grows with the size of that trader's positions. At some clearinghouses, domestic and foreign, it is customary for clearing margins to be scaled with position size. This is not, however, the practice at the largest domestic clearinghouses.[21] A statutory direction to require initial clearing margins in proportion to position size would serve to reduce clearinghouse exposure and, simultaneously, to make accumulation of oversized futures positions less attractive. The bursting of the silver bubble in March of 1980 would have been of far less concern had the precautions of gross margining and scaled margin levels been in effect before the trouble began.[22]

Among the most valuable devices for preventing the accumulation of oversized positions is the imposition of a speculative limit.[23] Although direct limits on speculative position sizes can be circumvented by sufficiently determined violators, the lack of perfect enforceability is no bar to their usefulness with respect to most market situations and market participants. Conscious of the dangers imposed by large speculative positions for both the pricing integrity and financial stability of futures trading, the CFTC has determined that there should be a reasonable limit on the size of such positions in all markets at all times.[24] This is a welcome and positive development. In connection with the pending establishment of limits by the exchanges, the CFTC has recommended a statutory amendment clarifying government's authority to enforce such limits.[25] I support this proposal and I would urge an additional statutory change as well.

The CFTC's speculative limits regulation grants to the exchanges a considerable measure of discretion in setting the new limits. They will have to exercise this discretion without the benefit of a long experience period in many of the younger markets. All indications are that most exchanges will resolve doubts in favor of relatively permissive limits.[26] Should a problem of congestion someday be perceived as arising even within the exchange prescribed limits, the CFTC will be powerless to intervene unless a genuine emergency is declared. Emergency powers are a poor substitute for precautionary medicines. The CFTC has the authority, after notice and hearing, to impose position limits of its own, but the statute specifically proscribes the CFTC from applying any such order to large positions already in place.[27] It was this proscription that compelled the CFTC in 1979 to rely on exchange position limits with respect to silver; the exchanges have the authority to set retroactive limits while the Commission does not. The declaration of an emergency is an unnecessarily broad remedy for an isolated large trader problem. To rely on the exchanges to employ retroactive power over position sizes inevitably exposes them to conflict of interest charges. The CFTC should be permitted, after due notice and hearing concerning specific market situations, to require reductions of excessively large speculative positions.[28]

---

[20] These recommendations were previously communicated to Congress in June of 1981 in "Additional Comments on the Interagecy Study of Silver Markets", Op. Cit. 17.

[21] *See* clearinghouse notices to members, July 7, 1981 and January 7, 1982, Coffee, Sugar and Cocoa Exchange for an example of how such a margining system could operate. Compare By-Law 604, Board of Trade (Chicago) Clearing Corporation.

[22] To assure the gross margining of futures and margins levels scaled to the size of positions, Section 5 of the Act could be amended to condition designation of a contract market upon provision for these precautions. The Commission has recently proposed a new Rule § 1.58, which would require positions held in an omnibus account by a non-clearing member to be margined on a gross basis. 46 Fed. Reg. 62864, December 29, 1981.

[23] I presented testimony on this subject at hearings on "Price Volatility in the Silver Futures Market" before the Subcommittee on Agricultural Reseach and General Legislation, Senate Committee on Agriculture, Nutrition, and Forestry, May 1, 1980. Additional remarks on this subject are contained in my 1980 Kimber Memorial Fund Lecture, Toronto, Canada, October 7, 1980; and Address at Conference on Financial Futures Sponsored by Columbia University Business School, New York City, January 29, 1981.

[24] Commission Rule 1.16, adopted October 1, 1981, requires all contract markets to establish speculative position limits on all currently traded futures contracts where position limits are not already in effect.

[25] See "CFTC Summary of Legislative Proposals", Section 4a(5) p. 10.

[26] See "CBT Committees Sharply Divided on Recommended Speculative Limits" Commodity News Service, January 6, 1982. CNS reported that the Chicago Board of Trade's financial instrument committee had recommended a 10,000 contract speculative position limits on most CBT interest rate futures contracts, while the Exchange's Business Conduct Committee recommended a 1000 contract limit.

The shield of secrecy surrounding large futures positions should also be reexamined by the Congress.[29] Small positions held by futures customers may be none of anyone else's business, but large positions have an impact on the entire market. Although secrecy may be of strategic benefit to the large trader, it is difficult to find a policy justification for not disclosing positions with a market-wide impact.[30] Economic theory suggests that a market is most efficient when supply and demand information is most widely distributed among the market participants. While knowing what a large trader owns at any time is not a perfect substitute for knowing what the trader knows, the position itself reflects a reasonable share of any proprietary information. If positions are revealed, the gains from the inside information become partially available to others and the whole market becomes correspondingly more efficient.

The argument most commonly raised against disclosure is that, in an environment of accustomed secrecy, a leak or unanticipated release of trading data could lead to market disruption. This implies only that disclosure would have to be the rule rather than the exception. Releasing large trader positions on a regular basis would diminish, not increase, the risks of market disruption through improper or ill-advised publication of market-sensitive data. Whatever may be the merits of disclosing current positions, moreover, there would seem an even clearer case for the release of stale and no longer sensitive data. Information on closed positions, however, is permanently shielded as though it remained forever market-sensitive. There are numerous benefits to the release of historical information. Producer groups and academics could use past data to examine market performance and market structure and to evaluate the actions of regulators and self-regulators as well. Enhanced study of position records might similarly help the Congress in exercising its oversight responsibilities. Justice Brandeis once said that sunlight was the best disinfectant. It may also be the best precaution against the need for a disinfectant.

The problems to be addressed in reauthorization are not limited to those involving organized futures markets. One of the least tractable obstacles faced by the CFTC since its inception will be largely removed if the Congress accepts the Commission's recommendation on expanded jurisdiction of the states.[31] Off-exchange dealers in commodity instruments have been routinely taking improper advantage of an ambiguity in the Act to shield themselves from appropriate state regulation and prosecution in state courts.[32] No one ever intended the CFTC to be an exclusive national police force for all commodity related crimes. The allocation of jurisdiction between the CFTC and state agencies with respect to off-exchange instrument sales is less than clear in the Act as now written. It will be all to the good, for both the public and the CFTC, if the Commission's proposal for an explicit affirmation of state jurisdiction over off-exchange instruments is made a part of the law.[33]

---

[27] Section 4a of the Act provides that: "the Commission may from time to time, after due notice and opportunity for a hearing . . . fix such limits on the amount of trading which may be done or positions which may be held by any person under contracts of sale of such commodity for future delivery . . . as the Commission finds are necessary to diminish, eliminate or prevent such burden (excessive speculation) . . . *Provided*, that such position limit shall not apply to a position acquired in good faith prior to the effective date of such order." (Emphasis supplied).

[28] This could be accomplished simply by the deletion of the proviso clause set forth and underlined in note 27.

[29] See James M. Stone, "Disclosure of Large Position Information", a speech at the Annual Convention of National Cattlemen's Association May 1, 1981. Also "Additional Comments on the Interagency Task Force of Silver Markets", Op. Cit. 17.

[30] Compare Trade testimony at hearings of the Senate Agriculture Committee 67 Cong., 1st Sess., (1921), Page 410.

[31] The Commission has recommended to the Congress an amendment of Section 12(e) of the Act to read:

"Nothing in this Act shall supersede or preempt: (1) any Federal criminal statute; (2) any Federal or State statute, including any rule or regulation thereunder, that is applicable to any transaction in or involving any commodity, product, right, service or interest which is not conducted on or subject to the rules of a contract market or subject to regulation by the Commission under Section 4c or 19 of this Act; or (3) the application of any Federal or State statute, including any rule or regulation thereunder, to any person required to be registered or designated under this Act who shall fail or refuse to obtain such registration or designation. The Commission is authorized to refer any transaction or matter subject to such other Federal or State statutes to any department or agency administering such statutes for such investigation, action or proceedings as the department or agency shall deem appropriate."

The Commission proposal, however, retains a federal preemption of state regulation in two areas where preemption is hard to support. The constitutional philosophy of the United States reserves to the fifty states broad powers to protect their citizens. The states should be entitled to all benefit of the doubt concerning their right to make and enforce those laws which they believe will benefit their citizens. The federal government should forbid the states to exercise their sovereign police powers only when there is an overriding national interest in uniformity across state lines and only when the federal government is capable of assuming the full responsibilities of public protection.

No one has argued that each state should impose its own rules concerning the specifications of contracts traded on national futures exchanges. The need for uniformity in contract terms is apparent, and the CFTC is a sufficient regulator. Assuming the existence of a responsible National Futures Association, the same logic would apply to the retailing of futures contracts by national firms. It requires a stretching of the logic, however, to preclude states from regulating the marketing of commodity pool shares. Under the proposed jurisdiction accord endorsed by the CFTC and the SEC, the SEC will be given primary authority for overseeing the capital formation stage of commodity pool operations.[34] This is presumably because pool shares are recognized to be neither hedging nor price discovery instruments; they are investment instruments. It is extremely difficult to distinguish them in this regard from mutual funds, and it seems accordingly inconsistent that the states should be permitted under the proposal to participate in the regulation of mutual funds but forbidden to play a parallel role with respect to commodity pools.[35] Unless Congress determines that capital formation in commodity pools embodies some greater national interest than the same process in mutual funds, parity of treatment would be the more advisable course.

The preemption of state regulation with respect to what are known as "leverage" contracts is without a logical foundation.[36] Neither the Congress nor the CFTC has ever identified an element of public interest in the sales of these deferred delivery instruments designed for speculation in precious metals.[37] Leverage merchants,

---

[32] *State* v. *Monex International, Ltd.*, 527 S.W. 2d 804 (Tex. Civ. App. 1975), application for writ of error refused, (Tex. Sup. Ct. No. B-5658, December 17, 1975); *International Trading Ltd.* v. *Harvey L. Bell*, Docket No. 77-96, Sup. Ct. of Arkansas (cert. denied); *Smith* v. *Green Valley Foods, Inc.*, Case No. 78-742 (Fla. Dist. Ct. App. 3rd), (January 9, 1979); The Commission has generally supported a strict interpretation of its exclusive jurisdiction clause.

[33] The CFTC proposal, quoted above in Note 31, received a favorable reception from its Advisory Committee on State Jurisdiction at that committee's February 5, 1982, meeting.

[34] See Commodity Futures Trading Commission/Securities and Exchange Commission Joint Press Release 853-81, December 7, 1981, and Commodity Futures Trading Commission/Securities and Exchange Commission Joint Explanatory Statement 882-82, February 2, 1981. The text reads in part:

"While the CFTC has adopted extensive regulations governing the activities of commodity pool operators and has exclusive jurisdiction with respect to "accounts . . . involving" futures, the SEC has taken the position that the activities of a commodity pool as a company, i.e., its formation, capital-raising, and continued corporate existence, are subject to the federal securities laws. The draft legislative language would make this result explicit by stating that nothing in the CEA affects the applicability of the Securities Act and the Exchange Act with respect to securities issued by commodity pools and transactions herein. Of course, the proposed language would not affect the exclusive jurisdiction granted by the CEA with respect to state regulation. . . ."

[35] Mutual funds are subject to SEC regulation under both the Securities Act of 1933, 15 U.S.C. § 77, the Investment Company Act of 1940, 15 U.S.C.§ 80a. Sections 18 and 50, respectively, of these Acts preserve state power to regulate as well. Commodity pools are legally distinct from investment companies.

[36] The Commission's provision for leverage firms in its legislative proposal is contained in the exception language of proposed Section 12(e) for contracts regulated under Section 19 of the Act and in new proposed language for Section 19 itself. It provides for a moratorium on the entry into the business of new firms until September, 1984, and further provides that within two years following the effective date of the provision, the Commission will conduct a study of leverage transactions and shall submit a report to the House Committee on Agriculture and the Senate Committee on Agriculture, Nutrition, and Forestry.

[37] The need for further study on the public interest in leverage transactions is questionable in the light of the long history of consideration of this subject by this Commission. Commission

Continued

unlike retailers of pool shares, will not be regulated by the SEC. The fledging NFA intends to take no responsibility for overseeing their selling practices.[38] The states would be entirely forbidden to regulate them under the CFTC's exclusive jurisdiction clause. So the CFTC, with a four person sales practice audit staff, would be their sole monitor. The CFTC staff believes it can do the job only if the leverage industry is restricted to the handful of firms which have enjoyed a federally imposed monopoly since 1978.[39] These lucky firms would be granted by the proposed legislative package a continued exemption from state regulatory oversight and a continued exclusive franchise to protect them from competition. In this era of awakened interest in the role of the states under federalism, it is disturbingly anomalous that state jurisdiction over this one element of off-exchange speculation in precious metals should be precluded. The CFTC package does acknowledge that further study on the matter is in order. If the Congress desires any further study, it should at least lift the preemption of normal state regulatory authority during the period of the study.[40]

The two remaining topics, customer protection and the standards of approval for the trading of new commodity contracts, are of special importance as underlying themes in a variety of futures market issues. Although both subjects have been implicitly addressed in my previous testimonies, this is my first opportunity, and perhaps my last as well, to offer my views in a broader context. I would like, therefore, to address these topics at some length.

Customer Protection.—When the Commodity Exchange Act was first drafted, there were very few commodity customers to protect and most of those were sophisticated enough to take reasonable care of themselves. Now that participation in futures and options trading has been extended to a general audience, including some customers possessing only the most casual familiarity with complex financial markets, the needs of the public have changed. The Act was conceived for an era which has passed. And its relative silence on customer protection issues has been interpreted too frequently as an absence of legislative mandate for the customer protection rules that today's markets so plainly require. Reauthorization provides an opportunity for Congressional direction which can help to bring the development of the industry's customer protection standards into step with its remarkable new product evolution.

---

exclusive jurisdiction over gold and silver bullion and bulk coin leverage transactions was established by Section 2(a)(1) of the Act and Section 217 of the Commodity Futures Trading Commission Act of 1974, 7 U.S.C. § 15a(1976). It was provided at that time that, should the Commission determine leverage transactions to be contracts for future delivery, the Commission was to regulate these transactions as futures contracts. The Commission began to study the subject of leverage transactions shortly thereafter. A study had previously been prepared by the Commodity Exchange Authority entitled "Report for the Commodity Futures Trading Commission: Trading in Leverage Contracts for Gold and Silver", and dated April 18, 1975. After the formation of the CFTC, an industry advisory committee was asked to conduct a further study of the leverage industry. See Advisory Committee on the Definition of Regulation of Market Instruments, 40 FR50557, October 20, 1975. The committee report entitled, "Report of the Commission's Advisory Committee on Market Instruments on Futures, Forward and Leverage Contracts and Transactions", was dated July 16, 1976. Next, an economic analysis was prepared by the Commission's Office of the Chief Economist. That analysis, concluding that leverage transactions were essentially contracts for future delivery, was discussed at the Commission's May 23, 1978 public meeting. The Futures Trading Act of 1978, Pub. L. no. 95-405, expanded Commission jurisdiction commodities other than gold and silver bullion. The Commission then requested its Enforcement Division to conduct a study of leverage transactions. See 43 FR56886, December 5, 1978. In September of 1978, the Commission's Office of General Counsel provided a legal memorandum to the Commission which was published for comment on March 12, 1979, 44 FR13494, recommending that the Commission determine to regulate leverage transactions as futures. In July of 1979, the Commission announced its intention to regulate leverage transactions as futures as of January 1, 1980, 44 FR44177, July 27, 1979. On November 20, 1979, the Commission determined to postpone the operative date of its decision on leverage transactions until June 1980. See 44 FR69304, December 3, 1979. On May 28, 1980, the Commission, citing a letter from its Congressional oversight committees, determined to postpone that determination once again until September 30, 1982. The Commission's legislative proposal postpones the decision yet again for two years.

[38] See transcript of CFTC public hearings on the application of the National Futures Association, June 4, 1981.

[39] See transcript of CFTC closed meetings on legislative recommendations in connection with reauthorization, January 26, 27, 28 and 29, 1982. There are only three firms currently active in the leverage business, according to the CFTC's Division of Trading and Markets.

[40] State regulatory jurisdiction during any study period, or permanently, could be effected simply by deletion of the reference to transactions subject to regulation by the Commission pursuant to Section 19 of the Act as it appears in the exclusive jurisdiction clause of Section 2(a)(1) of the Act and in the Commission's proposed language for Section 12(e).

The greatest weaknesses in commodity customer protection today are at the retail level. Despite an increasing similarity in both products and audience for marketers of commodities and securities, the commodities industry is substantially behind the state of the art developed in the securities industry over the years to protect customers from retailing abuses.[41] There is no requirement for uniform training or testing of sales personnel in the futures business. There are no suitability rules to restrict what an overzealous retailer may urge upon a commodities customer. There is virtually no self-regulatory police force to see that standards presently existing are enforced. Each of these failures serves to place the commodities customer in an unnecessarily vulnerable position.

The securities business has operated with all of these protections in place for decades.[42] The most reputable commodity firms have created their own in-house training programs, suitability standards, and compliance mechanisms. Less scrupulous firms, on the other hand, are free to have none of these safeguards. In a sense, one could describe the commodities retailing community as operating on a sort of honor system in which each firm can select its own standards of practice.

Everyone recognizes the right of a customer to adequate disclosure of risk. Without uniform training and testing of commodities sales personnel, customers can be deprived of any useful disclosure even by a well-intentioned sales representative who simply lacks an adequate knowledge of the product being sold. This variety of ignorant misrepresentation represents an escalating danger as the expanding marketplace calls for rapid recruitment of inexperienced sales personnel and as new and complicated derivative instruments, such as options on futures, are introduced. The Commission favors training and testing; at least one exchange requires it of member firms; and the NFA intends to initiate a testing program as soon as it is mature enough to do so.[43] This, however, is not sufficient. Congress should seriously consider requiring a proficiency testing program as a prerequisite to the marketing of any option or securities-based product. Industry-wide testing would probably follow quickly.

In the absence of suitability standards, it may well be legal for a commodity retailer to urge the proverbial widows and orphans of securities lore to risk their life savings or inheritances on positions so speculative or so large that they could be wiped out in a matter of hours. Recommendations urged upon securities customers, on the other hand, must be determined by the broker, and in some cases an office supervisor, to be suitable for the financial means and investment objectives of the customer.[44]

Suitability rules are often mischaracterized as attempts by government to determine whether individuals will be permitted to enter into transactions of their own choosing. They are, in fact, designed to influence only the behavior of sales representatives in recommending transactions to customers. The CFTC was urged by an advisory committee, comprised mostly of futures industry professionals, to establish suitability rules in 1975.[45] After considerable debate, it declined to do so.[46] In 1979, the CFTC staff revived the issue by proposing that suitability standards be adopted in connection with exchange-traded options. The Commission rejected this proposal as well.[47] Democratic government may never be able to prevent people from making fools of themselves. We should be able to discourage government licensees from taking advantage of those who trust them. Suitability rules are a minimum standard in this regard. It may now take the direction of Congress to assure that this minimum standard is met.

---

[41] My letter concerning the CFTC's proposed options pilot program provides to the Senate Committee on Agriculture, Nutrition, and Forestry a more detailed comparison of the state of the art in securities and commodities regulation.

[42] See letter of comment to the Commodity Futures Trading Commission from Irving M. Pollack, Commissioner, Securities and Exchange Commissioner, February 19, 1980.

[43] See 46 Fed. Reg. 20679-20683, April 7, 1981. The CFTC has published proposed rules which would require all new applicants for registration as associated persons to pass a proficiency examination as a condition of registration. The Chicago Board of Trade has a rule (1605 RCR-examination) requiring that member firm sales personnel pass a National Commodity Futures Exam. Other exchanges have, from time to time, adopted similar rules. There remains no industry-wide requirement and no coverage of sales personnel in non-member firms. Because the National Futures Association's by-laws include provisions for the establishment of a testing program (See transcript of CFTC hearings, op. cit. 38), the CFTC has not adopted any final rules on testing.

[44] See R. Mundheim, Professional Responsibility of Broker-Dealers: The Suitability Doctrine, 1965 Duke L.J. 445 (1965) and N. Wolfson, R. Phillips & T. Russo, "Regulation of Brokers, Dealers And Securities Markets," (1977), paragraph 2.08.

[45] See Report of the Commodity Futures Trading Commission Advisory Committee on Commodity Futures Trading Professionals, chaired by Commissioner Robert L. Martin, August 5, 1976.

[46] See 54 FR 31886, July 24, 1978. The Commission first rejected the proposed suitability rule at its public meeting of June 20, 1978.

The absence of a regulatory or self-regulatory monitoring capability with respect to sales practices in the futures business is especially worrisome. The SEC's staff is roughly four times the size of the CFTC staff, and it is supplemented by an NASD with 800 employees and with a mandate specifically directed toward the maintenance of high standards in securities marketing.[48] The CFTC has a small enforcement division and an even smaller sales practice audit staff.[49] The exchanges have always been candid in acknowledging that their rules and audit procedures seldom extend to influencing front-office retail practices.[50] The futures industry has recognized that a gap is present, and the proposal for a National Futures Association is an appropriate response. Unfortunately, no one is able to reassure the Commission that NFA will soon be able to accept the responsibilities of sales practice supervision.[51] The promise of an NFA has been long discussed in connection with new contracts which would enlarge the ranks of futures customers. At some point, that promise must be realized.

Congress may wish to take this opportunity to make clear that retail sales supervision is mandatory for a healthy and competitive market environment. There is little disagreement on this at the level of principle. The best contribution of reauthorization in this area would be to raise the priority placed by the industry on enhanced self-regulation by conditioning further growth in the customer base on better protections.[52] It is unfortunate enough that the requisite protections are lacking in traditional futures market domains. It would be all the more unfortunate if the approval by the CFTC of futures on securities serves to dilute customer protections where they have traditionally functioned well.

The need for vigilance, of course, extends to the exchange floor as well as the branch office. Floor brokers occupy a position of trust which, like other positions of trust, can be honored or abused. The customer in a futures trade, unhappily, has no direct way of knowing how scrupulously the trust was honored. A dishonest floor broker can hold a customer's order in his pocket while executing an identical order for an unspecified account, then decide later whether the trade was for himself, a colleague, or the customer. A broker can place his favored customers' large orders ahead of his smaller customers' earlier orders. Brokers can signal one another of an impending market pulse and thus allow the entire bid-ask spread to be moved to the detriment of customers in general. There is no way to be certain whether any of these abuses occur frequently enough to be a cause for substantial concern. Present technology permits no audit trail.[53]

In securities, a floor broker is not permitted to trade simultaneously for himself and his customers.[54] This practice, known in commodities as dual trading, is prevalent on the commodity exchanges.[55] Order executions in securities are time-stamped to permit sequencing and reconstruction of trading patterns for subsequent examination. Time-stamping more precise than to the nearest half hour has been described as infeasible in busy commodity pits. At the largest commodity exchange, executed orders are still dropped on the floors where they are picked up by runners for subsequent recording.[56] Congress was sufficiently concerned about commodity floor practices that, in 1974, it instructed the CFTC to conduct a study of dual trading and provided authority for the Commission to ban, limit, or condition dual trading on the exchange floors.[57]

---

[47] See staff document, prepared by the CFTC Division of Trading and Markets, concerning the Domestic Exchange-Traded Commodity Option Pilot Program, July 23, 1979, and transcript of CFTC public meeting on the opinions program, September 6, 1979.

[48] The Securities and Exchange Commission has 2150 employees according to its Office of Public Information. In contrast, the Commodity Futures Trading Commission presently has 471 employees (Source: CFTC Personnel Office).

[49] The Commodity Futures Trading Commission's Enforcement Division currently has 91 employees (Source: CFTC Personnel Office). The sales practice audit staff has four employees.

[50] See Testimony of Robert K. Wilmouth, President of the Chicago Board of Trade, and David Johnston, Chairman of Comex, at the CFTC public hearings on National Futures Association, Op. Cit. 38.

[51] See "NFA Board Opposes CFTC Recommendation for User Fees", Commodity News Services, February 1, 1982, in which an official of NFA is quoted as saying that consideration of user fees on commodity transactions renders prospects for the NFA in "grave doubt".

[52] This might be accomplished by supplementing the newly proposed amendments to Section 2(a)(1) of the Act in order to require that the Commission promulgate rules which assure that the customers in derivative securities instruments are afforded regulatory protection at least comparable to that provided in the primary markets under the securities acts and regulations.

[53] Customer abuse of the varieties described here would be violative of Commission Regulation 155.2, Trading Standards for Floor Brokers' (42 FR35009, July 7, 1977) and an array of exchange rules. The problem is that present trading and recordkeeping systems make detection and prosecution extraordinarily difficult. For additional discussion on the need for an audit trail, See "Regulation of the Commodity Futures Markets", a Report by the Comptroller General, General Accounting Office, May 1978, Pages 58-59.

[54] *See* SEC Rule 11a-1, 17 CFR § 240.11a-1 (1975). The securities options markets curtail these activities by prohibiting a single broker from trading the same instrument for both his own and any customer's account during the same trading session. See, for example, American Stock Exchange Rules 111 and 950.

The Commission quickly found itself in a dilemma it has never resolved. The extent of dual trading abuses could not be measured without an ability to reconstruct the sequence of trading. At the same time, every feasible method of sequencing required at least some change in the traditional technologies of the floor. The exchanges argued that a change in their accustomed methods should not be forced upon them absent a showing of abuse, while all parties agreed that no showing of abuse could be made without those changes which would permit trade sequencing.[58]

The CFTC, after laborious deliberations, sought a middle ground between the need for sequencing and the desire for minimum disruption of prevailing floor methods. Exchanges were instructed to time-stamp each trade report to the nearest one minute.[59] The result would approximate genuine sequencing, and the staff indicated that the requirement would be technologically feasible.[60] Several commodity exchanges complied, but the leading exchanges complained that even time-stamping to the nearest minute would slow the trading in their most hectic pits.[61] The CFTC reconsidered its position and ultimately decided to accept bracketing of trades to the nearest thirty minutes instead of the nearest one minute.[62] A thirty minute period is long enough for many of the feared abuses to occur within its time window and the data from thirty minute bracketing is too imprecise for use in the type of study originally contemplated. The questions posed by the Congress, therefore, remain unanswered.

If the Congress wishes a definitive response, it will most likely have to condition the continuation of dual trading at each exchange upon the exchange's willingness to provide accurate time sequencing. Alternatively, Congress may wish to let market forces aid in the solution. For reasons of private interest, it is probable that there will be changes soon in the traditional technologies of the pit auction. The demands of volume and the need for extended trading hours will force a modification of the nineteenth century techniques in use today. Congress should, at a minimum, make certain that whenever a new technology is developed it includes the capacity for accurate timing and sequencing of executed orders.

---

[55] A study performed for the Chicago Mercantile Exchange and submitted to the Commission in 1976 emphasized the prevalence of dual trading on commodity exchanges. For example, the report stated that approximately one-half of the volume in the lumber and live cattle markets was attributable to dual traders.

[56] Collection and recording of data is subject to a wide range of varying technologies at different commodity exchanges. In general, the older and busier the exchange, the more manual is the orientation of its trade and recording technology.

[57] Section 4j of the Act provides that "(t)he Commission shall within nine months after the effective date of the Commodity Futures Trading Commission Act of 1974, and subsequently when it determines that changes are required, make a determination, after notice and opportunity for hearing whether or not a floor broker may trade for his own account or any account in which such broker has trading discretion, and also execute a customer's order for future delivery and, if the Commission determines that such trades and such executions shall be permitted, the Commission shall determine the terms, conditions and circumstances under which trades and such executions shall be conducted: Provided that any such determination, at a minimum, shall take into account the effect upon liquidity of trading of each market . . ."

[58] A staff memorandum prepared by the CFTC Division of Enforcement describes the difficulty in the following terms: "Without a transaction reporting system which provides adequate market reconstruction capability, it will be virtually impossible for the exchanges to design trading surveillance systems to detect the forms of manipulative activities (especially reporting of non-existent transactions) which were encountered in the securities options markets. Moreover, any such violative conduct which may be detected will be very difficult to prove absent an audit trail." Staff Document, June, 1981.

[59] CFTC Rule 1.35(g), 41 FR46134, December 23, 1976, required implementation of one-minute time-stamping effective June 13, 1977.

[60] Ibid. (41 FR46134). See, also, Final Report of the Commission "Bracketing" Task Force, July 14, 1976, (public document, Commission files).

[61] See June 9, 1977 letter from New York Cocoa Exchange concerning Rule 1.35(g). Compare May 25, 1977 Petition of Chicago Board of Trade for relief from provisions of Rule 1.35(g), (public document Commission files).

[62] On November 26, 1980, the Commission adopted Rule 1.35a-(T) which eliminates one-minute time-stamping as a Commission requirement of and substitutes 30-minute bracketing. 45 FR79753, December 2, 1980.

A final and more general point about customer protection is also in order. If self-regulation and government regulation are the two front lines of defense against abusive practices, the courts constitute an indispensable third line of defense. Neither self-regulatory arbitration nor the CFTC's reparation system is an adequate substitute for the right to bring an action in a court of law. Arbitration achieves speed at the sacrifice of a written record and a written opinion. An arbitration judgment, consequently, can not be held to a standard of consistency with the common law, with the Act or even with other arbitrations. A customer reparations program at the CFTC, designed to provide litigants with all of the same rights assured by the Administrative Procedure Act, has proven itself too weighty a burden for the Commission's limited judicial apparatus.[63] The legislative proposal of the Commission recommends a more flexible approach to the adjudication of reparations complaints.[64]

The CFTC proposal is positive and appropriate as long as the reparations program can be viewed as a supplement to the aggrieved citizen's traditional rights of the suit. In cases presently pending before the United States Supreme Court, however, the right of commodity customers to bring suits under the Act has been challenged.[65] The Commission has voted to maintain its support for private rights of action under the Commodity Exchange Act. It has, to the same end, voted to request an explicit affirmation of these rights in the Act should its present position be rejected by the Supreme Court. On this, the entire Commission is in agreement.[66]

There is less than unanimous agreement on a related issue, however. While the Commission has reiterated its support for private rights of action against individual violators of the Act, the majority has voted to favor an exemption on behalf of commodity exchanges from any private lawsuits filed against them in connection with their self-regulatory duties.[67] I do not concur in the Commission's argument that exchanges are entitled to such a broad grant of immunity by analogy to government agencies. The case for self-regulation depends on the presence of a coincidence and congruence between the preferences of reputable private parties and the public interest. When an individual believes that he or she has been injured by a breakdown in that congruence, there must be recourse. Government power is bestowed on public servants only temporarily and only as conditioned by the full system of checks and balances as well as a host of prohibitions on conflicts of interest.[68] It should not be bestowed on private and interested parties without adequate judicial scrutiny.

The Commission believes itself to be a sufficient overseer of the self-regulatory powers vested with exchanges, and it fears that exposure to liability would chill the self-regulatory inclinations of the exchanges.[69] Earlier, however, the Commission had taken the position in court that it could not provide adequate remedies or compensation for parties injured as the result of unlawful self-regulatory activity or negligent inactivity.[70] With respect to the chilling effects on commodity exchanges

---

[63] The number of reparations cases pending before the CFTC's Hearings Section rose from 343 at the end of fiscal year 1978 to 700 in 1979, 1172 in 1980 and 1389 in 1981. (Source: CFTC Office of the Executive Director.)

[64] The CFTC's legislative proposals includes several amendments to Section 14 of the Act. The effect of these amendments would be to permit the Commission substantial discretion in determining the rights of parties and procedures applicable under the reparations program.

[65] *Clayton Brokerage Co. of St. Louis, Inc.* v. *Leist, Smith and Incomco* No. 80-895; *New York Mercantile Exchange, Levie, Gabler, and Pennisi* v. *Leist, Smith and Incomco,* No. 80-775; *Heinhold Commodities, Inc., Thomson & McKinnon Auchinloss Kohlmeyer, Inc.* v. *Leist, Smith and Incomco,* No. 80-936, *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Curran,* No. 80-203.

[66] CFTC meeting on reauthorization, Op. Cit. 39.

[67] Ibid.

[68] The Commission has not offered any legislative recommendations specifically directed toward the subject of conflicts of interest. It is apparently the view of the Commission and the staff that no practical and comprehensive solution to this problem is available consistent with a continued emphasis on exchange self-regulation. None, at least, has been suggested.

[69] CFTC meetings on reauthorization, Op. Cit. 39.

[70] In *Smith v. Groover,* Civil Action No. 77C 2297 (N.D., Illinois), the CFTC filed a memorandum amicus curiae in which it stated: "Even if the Commission did have the resources to bring its enforcement powers to bear upon all apparent violations of the Act—which it does not—those powers provide no mechanism for compensating persons who may have been inured . . .", at 25, and "To the extent exposure to liability might inhibit exchange self-regulatory efforts, however, we believe that this possibility can generally be ameliorated by the imposition of a standard of culpability which balances the interests . . .", at 27.

The CFTC's legislative proposal may be contrasted with its current stance as amicus curiae in a case before the Supreme Court, *Clayton Brokerage Co. of St. Louis, Inc.* v. *Leist, Smith and* of potential liability, the Commission had earlier commented that any such danger could be ameliorated by the use of a liability standard which balanced the inhibitive effects of a right of action against the beneficial effects of judicial scrutiny.[71] The Commission turned away from this approach at its recent meeting when it rejected a proposal to permit private rights of action against exchanges in cases alleging gross negligence or gross dereliction of self-regulatory duties.[72] The previous position of the Commission on this matter is more sensitive to the requirements of public protection than the CFTC's current view, and I hope that the Congress will assure that there are no unwarranted barriers to the right to bring private lawsuits under the Commodity Exchange Act.

Approval of New Contracts—The futures industry has been transformed by its own new products in recent years. Another wave of innovative products is emerging now with the potential for an equally dramatic impact. The Commission last year authorized the first futures contracts calling for cash settlement in lieu of physical delivery.[73] The Commission has voted to permit exchange trading of options on futures, and it is prepared to support a fresh look at the longstanding ban on agricultural options.[74] Just a few days ago, the Commission approved a controversial application for futures trading on an index of common stocks. Consistent with a stated goal of expediting the consideration of new product applications, the CFTC has authorized some nineteen new contracts within the last year. Before us and pending approval are applications to trade futures on seventeen additional common stock groupings and on the prime rate.[75]

When economic historians look back on this part of the Twentieth Century in America, one can expect them to pay close attention to our dismally low rate of real capital formation. By the standards of this country's past and by comparison with our industrial rivals today, America is simply not investing sufficiently in its own future.[76] Many explanations are available, placing the blame variously on government deficits, on rigidities in wages and prices, or on the lack of personal savings incentives. There is probably an element of truth in most of the widely held theories, but I also believe it is far from coincidental that the slowdown in capital formation should be occurring at a time when speculation is so widespread. Along with

---

Incomco, No. 80-895; *New York Mercantile Exchange, Levie, Gabler, and Pennisi* v. *Leist, Smith and Incomco*, No. 80-775; in which its memorandum states: "Because establishing that manipulation has occurred or that an exchange has breached its self-regulatory duties often requires costly and complex litigation, private rights of action in this context are a particularly important supplement to the Commission's enforcement effort. Moreover a possibility of private suits provides a meaningful incentive for commodity exchanges to exercise an appropriate degree of vigilance in performing their self-regulatory duties." at 2.

To grant exchanges and their officials a complete exemption from private damage suits would, of course, provide a protection beyond that available to public officials under prevailing law. *Compare Butz* v. *Economou*, 438 U.S. 478 (1978), at 507.

[71] Ibid., *Smith* v. *Groover*.

[72] CFTC meeting on reauthorization, Op. Cit. 39.

[73] The Commission designated the Chicago Mercantile Exchange a contract market in Three Month Eurodollar Time Deposit Rates (settled in cash based upon the London Interbank Interest Rate) on December 8, 1981.

[74] CFTC meeting on reauthorization, Op. Cit. 39.

[75] The Chicago Board of Trade has eleven stock index contracts pending for Commission approval including an Industry Composite Portfolio; an Air Transport Portfolio, an Automotive Portfolio, a Banking Portfolio; a Chemical Portfolio; a Drug Portfolio; an Information Processing Portfolio; a Petroleum Portfolio; a Photo-Optic Portfolio; a Retail Portfolio; and a Telecommunication Portfolio. The New York Futures Exchange has stock index contracts pending on the New York Stock Exchange Composite Index; the NYSE Financial Index; the NYSE Transportation Index; and the NYSE Utility Index. The Chicago Mercantile Exchange has a proposed contract pending designation on the Standard & Poor's Composite Index. The Commodity Exchange Inc., has pending a contract based on a 500 stock composite index. The Chicago Board of Trade has submitted to the CFTC a futures contract based on the prime rate charged by the major domestic banks.

[76] Personal savings, one of the principal sources of real investment capital, averaged 6.8 percent of disposable personal income in the U.S. during the 1950's, fell to 6.6 percent in the 1960's, to 5.7 percent during 1976-79, and then to 5.3 percent during 1981. In contrast, the personal savings rate during 1980 was 14.5 percent in West Germany and 14.3 percent in France. During 1979, it was 18.3 percent in Japan. (Source: Bureau of Economic Analysis, U.S. Department of Commerce).

Gross fixed capital formation as a percentage of GNP during 1980 was 17.8 percent in the U.S., 21.6 percent in France, 23.4 percent in West Germany and 31.8 percent in Japan, according to the U.S. Department of Commerce, International Trade Administration's International Economic Indicators, December, 1981.

pure gaming in casinos, pools and lotteries, speculating on real estate, precious metals, the stock market and commodities has replaced baseball as the national pastime. At no time in American history, with the possible exception of the late 1920's, has the hunger of our people for a quick buck been greater or more evident.[77]

Speculative fever is not a prime mover in the decline of capital formation as much as a symptom of the deeper causes. It may, however, intensify the basic economic problems and help the absence of real growth to become a self-fulfilling prophecy. Chronic inflation is probably the worst enemy of capital investment. Facilitated by natural processes of age in the U.S. economy and by our weakened worldwide competitive position, inflation has introduced an uncertainty and dimmed the prospects for high real returns in American industrial investment over long periods. Savers and lenders have thus focused on the short end of the financial time horizon where, unfortunately, there is little opportunity for building the future. The more this concentration in short term instruments occurs, the worse the economy's long term prospects will actually be and more the real capital sector will continue to deteriorate.

The ultimate short horizon investments are those with perfect liquidity, those which can be bought today and cashed in tomorrow. New manufacturing plants can never meet that test, but speculative positions in active markets come relatively close. When nominal interest rates are high and real rates are low, moreover, those speculative investments which embody a high degree of financial leverage take on an additional measure of appeal.[78] Speculation under these circumstances may provide the only hope many investors have for high returns over short periods. The remarkable growth of the futures markets during the last decade undoubtedly owes much to the underlying conditions which favored short maturities and high leverage.

It is commonly said in defense of speculation that it can occur without limit at a zero cost to the real economy because, rather than consuming physical capital, it merely shifts money from one hand to another. The truth is neither so simple nor so rosy. Concentration on unproductive speculation, at the very least, absorbs the time and talents of all who participate. This cost is hard to measure but unquestionably large. A count must include all the career people who advise, sell, and trade in the various speculative markets and all those who work in the pure gaming industries. To this total would be added all the time and energy devoted to speculation by the amateur participants. Some of this cost is reimbursed to the economy as a whole in the form of efficient markets; most of it is not. The loss is surely not trivial in a society which needs all the constructive effort it can muster.

Widespread speculation may have a diversionary impact on the supply of investment funds as well. Real capital formation dollars and financial speculation dollars do not come from the same finite pool in the simplest sense. Capital formation and speculation do, however, compete for the attention of the same risk-takers, and they operate on the economy's liquidity structure in competing and incompatible ways. An economy which devotes its financial resources to plant and equipment development must sacrifice some degree of liquidity in the composition of its financial assets. Individuals living in a society which emphasizes speculation, on the other hand, must stay highly liquid in order to meet the next margin call or enter the next position. The more the public seeks to maintain the liquidity necessary for speculative activities, the smaller will be the supply of funds available for twenty or thirty year real asset commitments.

This trade-off creates a logical dilemma for the current Administration, which places a supply-side emphasis on the growth of our real capital base, but also wishes to maintain a laissez-faire attitude with respect to regulation and questions of allocation in financial markets.[79] Speculation thrives in the marketplace, and it has powerful constituents within the financial community. If, at the same time, massive speculation is detrimental to the growth of industrial capital, the Administration will not be able to serve both masters well. Government, moreover, has no option to take a neutral stance. That fostering long term growth is a responsibility of government is accepted by conservatives and liberals alike. Numerous elements of federal tax, expenditure and monetary policies inevitably influence the incentives that determine our national economic priorities. A governmnent wishing to stimulate growth can not be a promoter of more speculation.

---

[77] On February 7, 1929, the Federal Reserve Board of Governors issued a statement warning of the "excessive amount of the country's credit absorbed in speculative loans" and asked member banks to refuse additional loans for market speculation. "The Day the Bubble Burst." G. Thomas and Max Morgan-Witts, Doubleday & Co., 1979, page 61.

[78] See The Commission's 1981 "Report to Congress in Response to Section 21 of the Commodity Exchange Act," Pub. Law 96-276, 96th Congress, 2d Sess., Section 7, 94 Stat. 542, pages 49-50.

[79] This issue creates some strange intellectual alliances. George Gilder, a leading neo-conservative, has written that (as the 1980's began) . . . "The upper classes, normally the cutting edge of the economy—the source of most investment—fled to unproductive tax shelters and hoards of gold, real estate, and speculation." He continues: "The economy is reoriented away from productive enterprise and toward Caribbean resorts and early retirements. The land, the precious metals, the works of art just sit there, growing more valuable for a while, but for the most part contributing little to the welfare of the people or the productive capital of the economy" and

The commodities industry and the CFTC are, of course, only minor players in this drama. Neither are to blame for the macroeconomic problems of the nation. Nonetheless, because speculation in futures has grown so rapidly and because government policy toward futures markets is still in a formative stage, the broader issues are particularly well framed in this context. Virtually every economist would agree that speculation in futures markets, when conducted in moderate amounts by knowledgeable participants, is a contributor to microeconomic pricing efficiency.[60] The issue requiring scholarly and Congressional attention today is the impact of speculation, particularly when carried beyond moderation, on macroeconomic goals.[61] The CFTC staff, understandably, has not sought to examine all of the macroeconomic consequences of futures speculation in connection with new contract applications. Its approval process has a narrower focus in keeping with the current state of the law. Reauthorization provides a useful opportunity for the Congress to reconsider and sharpen that focus.

Congress has never considered the marketplace test sufficient for the justification of a new futures contracts. Pure gambling has always held its own in free market situations, and so have sales of contrabands. The existence of willing buyers and willing sellers is a necessary condition for the creation of a new futures market, but it is not the only standard by which a new trading instrument should be judged. Congress has expressed its desire for a more substantive test by requiring a determination that each new contract will not be "contrary to the public interest".[62]

The legislative history of the public interest test makes clear that the Congress wished to have the CFTC approve only those futures contracts which would serve a genuine economic purpose and to preclude contracts used entirely or almost entirely for speculation.[63] Consistent with this legislative history, the CFTC codified its standards in a statement that each new contract would be required to show poten-

---

observes that "Speculation abounds in existing commodities, in land and gold and art, or in gambling stocks, while the durable capital of the nation—necessary for all its further wealth—wastes away." G. Gilder, "Wealth and Poverty," Basic Books, 1981. Pages 20, 42 and 189.

[60] See Smith, Adam, "The Wealth of Nations," Dutton, New York (1936) page 24; Mill, John Stuart, "Principles of Political Economy," August M. Kelley, Fairfield (1976) pages 525-8; Marshall, Alfred, "Principles of Economics," page 26.

[61] Various members of Congress have, from time to time, expressed concern over the lack of knowledge on this subject. See letter to CFTC from Congressman Benjamin S. Rosenthal, Chairman, Subcommittee on Commerce, Consumer and Monetary Affairs, House Committee on Government Operations, February 10, 1982 and letter to CFTC from Congressman John D. Dingell, Chairman, House Committee on Energy and Commerce, February 5, 1981. In "Additional Views" attached to the House Report on the legislation reauthorizing the CFTC in 1978, Congressman Dan Glickman noted: "no one, not the CFTC, not the SEC, not OMB and not GAO, has any substantive ideas on how much money has moved out of the equity markets and into the futures markets during the past several years. In fact, no one in a position to know seems to have the foggiest idea on how the development of futures on financial instruments, including securities will affect our capital markets and economy in general." Glickman went on to say that "given the potential for significant impact on our economy and the rapidly changing nature of the futures industry," such data should be compiled and evaluated.

[62] The public interest test is set forth in Section 5(g) of the Act. The Act authorizes and directs the Commission to designate a contract market in a particular commodity future, when and only when, among specified other things, the "board of trade demonstrates that transactions for future delivery in the commodity for which designation as a contract market is sought will not be contrary to the public interest."

[63] In explaining the statutory language concerning the public interest, Mr. Talmadge, then Chairman of the Senate Committee on Agriculture, Nutrition and Forestry, stated: "The committee intends by its language to broaden the scope of the test which the Commission must apply before designation of a particular contract market .... Clearly, if a market were being used almost entirely for speculation rather than for legitimate hedging, it would not be in the public interest." (September 9, 1974, Cong. Record, Senate 30467-8). The Conference Report on the Act states, p. 36: "The Conferees note that the broader language of the Senate provision would include the concept of the "economic purpose" test provided in the House bill subject to the final test of the "public interest". The House bill had set forth a more specific hedging or price-basing standard. S. Rep. No. 1194, 93rd Cong., 2d Sess. 36 (1974) (Report of the Committee of Conference).

tial for "more than occasional" commercial hedging or price basing.[84] Implied in this formulation is that the commercial activity to be served is of important positive benefit to the economy. Players on a professional sports team could hedge their earnings prospects in a contract on the team's record. Dealers could hedge and discover the market prices in an illicit drug contract. These contracts would never be filed by an exchange or approved by the CFTC. The difficult questions arise when a valid economic purpose to be served by a contract is weighed against potentially detrimental effects of trading.

Some observers hold the view that the commercial purpose standard for a contract is met as long as there exists any hedging potential at all, however remote or limited. The actual process of CFTC consideration focuses heavily on the identification of likely hedgers and the terms that affect their use of the contract. The specifications are carefully examined to assure fairness to those who would deliver or take delivery under the contract. The CFTC staff will suggest changes in the specifications if it finds that the contract is easily susceptible to manipulation. It will determine whether the exchange submitting the contract is complying with applicable laws and regulations and whether it is maintaining a sufficiently vigilant program for enforcing its own rules. On some contracts, there is consultation with other government agencies about concerns in their areas of responsibility.[85] By the time these tasks, and others that may be occasioned in a specific case, are completed, the application has generally been improved over the original submission. The contract then moves forward to final approval. No contract application has ever been denied by the CFTC.

Exchanges often complain that the approval process is time-consuming. This is true, but it is nonetheless valuable. Competition between exchanges can test only some of a new contract's terms and specifications. To assume that no unfair advantage is taken at the expense of the commercial and producer communities, some degree of oversight has always been seen as necessary by the Congress and the regulatory agencies. My concern in this area is not with the questions asked but with the questions not asked.

The public interest test ought not to be viewed as a binary, yes or no, exercise in which commercial value is found to be either present or absent. Commercial value is a matter of degree and the public interest test ought to be a weighing of costs and benefits. The benefit side of the equation for a new futures contract includes the hedging and price discovery purposes it will serve. A contract expected to be utilized heavily in commerce conveys more benefits than one lightly used. On the cost side, the test must consider any predictable dangers of abuse with respect to the likely customer population, any adverse effects that may be felt in underlying cash markets, and the impact on macroeconomic capital formation that may be caused by a high level of speculative activity.

Commodity options trading in its earlier incarnation offered a good illustration of how abusive retailing practices can undermine the public interest in a trading instrument. Both Congress and the CFTC eventually reached the conclusion that the abuses were so great as to overwhelm any benefits from off-exchange options trading. Commodity options were banned as a result, and the Congress ordered that they remain banned until the CFTC had documented its ability to regulate them successfully.[86] Although the CFTC's proposed system of protections remains behind the present state of the art in options trading on national securities exchanges, the options program of the CFTC is distinctly superior to its customer protection program in futures markets. It contains an enhanced disclosure rule with respect to the opening of accounts and it requires exchanges to establish rules and audit programs for the monitoring of member firm retail practices involving options.[87]

---

[84] On May 13, 1975 the Commission published its Guideline 1, which sets forth the standards proposed contracts must be met in order to be designated. Guideline on Economic and Public Interest Requirements for Contract Market Designation, Commodity Futures Law Reporter (CCH), Paragraph 6145. Also, See Report of the Comptroller General (1978). Op. Cit. 53.

[85] Section 2(a)(8) of the Act requires CFTC solicitation of comments from the U.S. Treasury Department and the Federal Reserve Board on pending futures contracts involving securities issued or guaranteed by the U.S. government. The Commission's proposed legislative package would amend Section 2(a)(1) of the CEA to require that upon application by a board of trade for designation as a contract market in a stock index futures contract, or option on such a contract, the Commission shall provide an opportunity for public comment on such contracts and consult with the Securities and Exchange Commission with respect to such designation.

[86] In 1978, Section 4c(c) of the Act was added prohibiting, with certain exceptions, any option transaction involving any commodity regulated under the Act until "the Commission transmits to the House Committee on Agriculture and the Senate Committee on Agriculture, Nutrition and Forestry, documentation of its ability to regulate successfully such transactions. . ."

[87] 46 F.R. 54500, November 3, 1981

Were the Commodity Exchange Act to express the same explicit concerns about customer problems in futures contracts that it expresses in the case of options, the CFTC could use the contract approval process to upgrade the industry's level of customer protection generally. Under current law, the staff is reluctant to suggest that any new futures contract be held to a higher standard than the futures contracts which preceded it. It was on this basis that stock index futures, which several agencies of government have warned us may embody substantial potential for customer abuse, were approved by the CFTC with a set of protections markedly weaker than those applied to options.[58]

Consideration of the effects that the terms and conditions of a proposed futures contract will have on the underlying cash markets is a significant part of the CFTC review process. Neither the staff nor the exchanges are asked to project speculative activity, however, and consequently the effects of speculation in the proposed contract on underlying markets are less studied. While it is true that a moderate amount of speculation carried on by well informed individuals should aid in the efficiency of markets, it is just as true that immoderate or uninformed speculation is likely to hurt pricing efficiency.[59] Part of the contract approval process should be an evaluation of means to hold immoderate and uninformed speculation in check.

The recent adoption of a rule requiring position limits in all markets may be viewed as a useful step in this direction. Position limits should reduce the problems caused by excessively large traders. Remaining, however, is the problem caused by masses of smaller uninformed traders. Under the CFTC's present reading of the Act, no distinction is drawn on the basis of whether the hedgers who use a market are accompanied by a few hundred, a few thousand or a few million speculators. Many of the currently successful futures markets are predominantly speculative, some with a hedging interest of ten percent or less. Some degree of knowledgeable speculation is necessary to lubricate the machinery of the futures markets. It does not follow from this observation that, beyond the point of adequate liquidity, more speculation is always better. There is every reason to believe that market efficiency is adversely affected by the presence of undercapitalized and ill-formed participants. This will be especially the case during a time of market disruption or rapidly changing fundamentals.

The CFTC Division of Economics and Education has compiled statistics which indicate percentages of long and short speculative participation in the following contracts for fiscal 1979.

Commodity	Market	Long	Short
Gold	IMM	92.5	87.7
	Comex	81.3	73.1
Silver	CBT	95.9	91.0
	Comex	85.6	76.0
U.S. T-bills (90-day)	IMM	83.9	77.5
Frozen pork bellies	CME	94.2	84.9

Source: Staff document prepared in connection with the designation of the Kansas City Board of Trade as a contract market in the Value Line Average, February 1982.

The best policy device for limiting excessive speculative participation is margin control. Selective use of margining powers can adjust the prospective level of public speculation to that required as a market lubricant and keep it from overwhelming the commercial participation. If the present vesting of margin authority with the exchanges is maintained, the CFTC should at least be empowered to seek assurances during the designation process that the exchanges' authority over margins will be used in this manner.

The grand question, whether massive speculation has an adverse macroeconomic effect on capital formation, is never considered by the CFTC as a part of contract designation. It transcends any single contract application, and it also transcends the mandated expertise of the Commission. Nothing we do consider, though, is of equal importance. The role of futures markets in the economy will ultimately be judged more on macroeconomic grounds than by the narrower standards applied day to day. The Congress may wish to consider requiring a periodic interagency study of the macroeconomic questions. The Department of the Treasury, the Securities and Exchange Commission, and the Federal Reserve Board of Governors would be natural candidates for participation with the CFTC on any such studies.[90]

---

[58] See transcript of CFTC open meeting concerning designation of the Kansas City Board of Trade as a contract market in the Value Line Average of common stock, February 16, 1982.

[59] The general point is well established in classical literature, but the impact on markets of uninformed or oversized traders is not well studied in the modern academic literature of financial markets.

The meaning of the Act's public interest test should, meanwhile, be clarified to dispel the notion that it is one dimensional and binary. The potential for abuses with respect to customers, the micro-efficiency impacts of anticipated speculation, and the broader macroeconomic theory questions should all be elements in the designation equation. Where deficiencies are found there should be a maximum of emphasis on the improvement of the application. A marketplace test, of course, is needed as well. Because, however, the marketplace is not designed to judge all of the elements of the public interest, periodic review of actual trading performance should be viewed more as a supplement than a substitute for the process of prior approval. A prospective and analytical test, however difficult to perform, has always been required of the Commission under the Act. This continues to be both proper and necessary. An explicit prior weighing of the costs and benefits, including the anticipated degree of commercial value, should accompany the marketplace as the judge of new futures markets.

Deregulation is the fashion in Washington today. In the spirit of deregulation, various proposals have been offered which would strip the Commodity Futures Trading Commission of much of its present authority over futures and option markets.[91] Whatever may be the merits of deregulation in other commercial areas, a reduction of government oversight in futures and option markets would be contrary to the country's needs and inconsistent with the industry's own development. With the expansion of these markets and their enlarging role in the aggregate economy, there should be more, rather than less, public attention paid to them. I hope the Congress will embrace the constructive proposals of the Commission and will also consider the additional matters I have raised in this testimony. Please do not hesitate to call on me if I can be of service during the deliberations.

Very truly yours,

JAMES M. STONE.

[The following information was requested by Senator Dole:]

COMMODITY FUTURES TRADING COMMISSION,
Washington, D.C., March 25, 1982.

Hon. RICHARD G. LUGAR,
Chairman, Subcommittee on Agricultural Research and General Legislation, Committee on Agriculture, Nutrition, and Forestry, Russell Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: This is in reply to the request of Senator Robert Dole during your Subcommittee's hearings on extending the Commodity Exchange Act on March 1, for the Commission to expand its views on the effect the National Futures Association ("NFA") will have on the duties and functions presently performed by the Commission.

It has been suggested that NFA's assumption of some of the Commission's duties will allow Congress to reduce the Commission's budget by up to $12 million—a substantial savings if it were true. Although NFA will relieve the Commission of some of its present operational responsibilities, NFA's estimates of Commission savings appear to be substantially inflated and, moreover, the Commission will need much of the resources that will be freed by NFA to keep pace with the orderly growth of the industry in the years ahead.

As you are already aware, the Commission has taken a number of initiatives in recent months—of which the establishment of a pilot program for the exchange trading of commodity options is but one example—to remove unnecessary obstacles to the continued growth of the industry and to the usefulness of the futures markets to those, such as farmers and merchants, who benefit from their operation. However, many of these initiatives were predicated upon the assumption that NFA would allow the Commission to reallocate its own resources to other matters, such as the review of an expanding number of new futures contracts and general oversight of the exchanges' and NFA's self-regulatory programs.

---

[90] Such a study might be most valuable if extended to all financial markets. The Treasury and Federal Reserve conducted a study of futures markets in 1979 but did not reach the macroeconomic issues. "Treasury Futures Markets: A Study by the Staffs of the U.S. Treasury and the Federal Reserve System, May 31, 1979." In addition, pursuant to Section 21 of the Commodity Exchange Act, Op. Cit. 78, the Commission was directed to establish a joint working group with the Federal Reserve Board, Treasury, and the SEC to analyze and prepare a report on the events in the silver market during the period of September 1979 through March 1980. The study was expanded to include an analysis of financial futures markets as well. The study was thorough and valuable, but here, too, the macroeconomic effects were not directly addressed.

[91] See, "Journal of Futures Markets," Volume 1 Supplement, pp. 461-486, for summaries of a number of these proposals.

The specific effect of NFA on the agency is as follows:

DIVISION OF TRADING AND MARKETS

NFA initially plans to register futures commission merchants ("FCMs") and their associated persons, and ultimately, to register commodity trading advisors and commodity pool operators ("CPOs"). These persons would, however, continue to be registered formally with the CFTC. (By comparison, floor brokers, who would not be members of NFA, would not be screened by, or registered with, that organization.) If NFA were to assume total responsibility for registration processing—including, for example, the registration of floor brokers and of any additional categories of registrants which may result from changes in the Act—the Commission anticipates that it could save eleven staff years and $234,000. Furthermore, the Commission could save an additional seven staff years and $140,000 if NFA were to investigate for the Commission information which may reflect adversely upon an applicant's fitness for registration. In that event, the Commission would still require two staff positions for the purposes of oversight and coordination with NFA and to respond to public inquiries relating to registration matters.

NFA has indicated to the Commission that it intends to commence financial audits of those futures commission merchants who are not members of a contract market within one year of its registration with the Commission—i.e., by the beginning of fiscal year 1983. (NFA also plans to audit the books and records of CPOs, although it has indicated that it will not phase in a CPO audit program until it has first registered futures commission merchants and their associated persons, commodity pool operators, and commodity trading advisors, and established an ongoing audit program for FCMs). The successful implementation of the first phase of NFA's financial audit program—auditing non-member FCM's compliance with the minimum financial (net capital) rule for FCMs and the related reporting requirements—should allow the Commission to reduce its audit staff by four positions at a savings of $132,760. Similarly, when NFA establishes a program for the financial auditing of CPOs, the Commission will be able to reduce its audit staff by an additional five staff years, with a resulting savings of $165,950.

NFA does not presently intend, however, to monitor FCMs' compliance with the requirements relating to the segregation of customers' funds or the associated recordkeeping; if it did, the Commission anticipates that it could save an additional four staff years and $132,760. Still another two staff positions could be eliminated if NFA were to audit dealer option grantors and leverage transaction merchants, although NFA has not thus far indicated that it plans to do so. Finally, if NFA were to assume the responsibility for monitoring exchange-member FCMs' compliance with the minimum financial requirements, the Commission's audit staff could be further reduced by three staff years because the Commission's oversight activities could then be focused on one—rather than eleven—self-regulatory organizations. (There are no current indications, however, that NFA is prepared to assume the exchanges' current responsibilities in this area or that the exchanges are willing to cede those responsibilities to NFA.) Thus, the Commission will continue to have both direct audit responsibility for a substantial portion of the industry as well as the responsibility for the oversight of NFA's and the exchanges' audit activities.

The Division of Trading and Markets does not anticipate any cost savings in contract market oversight to flow from the existence of NFA. The NFA has explicitly stated that it does not intend to supplant the rules, programs or other regulatory functions which traditionally have fallen within the regulatory domain of the contract markets. Moreover, the exchanges have been adamant that NFA not be a vehicle for encroachment into those areas where they traditionally have exercised regulatory responsibility. Accordingly, the Division has no basis to believe that its workload and efforts in overseeing the contract markets can be expected to diminish by virtue of NFA's activities. On the contrary, the additional responsibility of overseeing the NFA—particularly in the areas of rule review and rule enforcement—will increase the demand on Division resources already dedicated to the similar but separate oversight of contract markets.

Finally, NFA intends to conduct a comprehensive program of sales practice ("front office") audits of futures commission merchants (including exchange-member FCMs), commodity pool operators, and those commodity trading advisors who manage customer accounts. (NFA has not indicated that it intends to conduct similar sales practice audits of leverage transaction merchants or of dealer option grantors.) The Commission has begun to develop a Front Office Audit Unit which, because it presently consists of only five persons (inclusive of support staff), is not able to do more than engage in spot audits of selected firms on either a scheduled or an emergency basis. Thus, even if NFA has fully implemented its sales audit program by fiscal year 1984, the Commission anticipates reducing its staff in this area by no more than one person. The remaining staff in this area would enable the Commission to oversee NFA's activities, to continue to audit those firms who are outside the scope of the NFA program, and to provide necessary assistance in emergency situations (e.g., where customers' funds are in jeopardy).

In conclusion, the Commission estimates that the staffing level of the Division of Trading and Markets could be reduced by a maximum of 37 positions if NFA becomes fully operational by fiscal year 1984 and if, in addition, NFA satisfactorily implements the performance of a wide variety of tasks which, thus far, it has not indicated that it intends to perform.

OFFICE OF THE GENERAL COUNSEL

The Office of General Counsel serves an essentially reactive and advisory function by (1) providing legal advice to the Commission and to its staff upon request, (2) reviewing for legal sufficiency regulatory and enforcement proposals initiated by the Commission's operating divisions (Economics and Education, Trading and Markets, and Enforcement), (3) defending the Commission in litigation brought against the agency, (4) preparing and advising with respect to Commission orders and opinions in administrative enforcement and reparations cases, and (5) representing the Commission in the appellate courts in order to sustain those orders and decisions when they are challenged.

Administrative enforcement actions include both prosecutions for those who violated the law and proceedings to deny or revoke registrations of commodity professionals. While the NFA can be expected to upgrade and supervise industry standards, there will continue to be, of necessity, actions brought to enforce the law against those who may be in violation, whether or not they are members of NFA.

Similarly, while the NFA may be authorized to perform some of the Commission's registration functions, this is not expected to include Commission review of denial and revocation of registration of commodity professionals ordered by the NFA. As a consequence, the Commission will still be called upon to issue opinions and orders in such cases and to defend its position in the appellate courts. Moreover, it should be noted that futures associations are authorized to deny membership in the association to commodity professionals and any such denials are appealable to the Commission. As the NFA becomes operational, the Commission will have to develop rules to hear such appeals, and it can be expected that court litigation may result from a person's being denied membership in the organization.

Furthermore, the NFA's arbitration procedures are calculated to encourage fewer customers to seek redress of their grievances in the Commission's reparations forum. As a consequence, we hope that there will be fewer such cases for the Commission to review although the potential relief is incalculable at this time and, in view of the existing backlog of reparations cases, the salutory effect of any such diminished caseload may not be felt for the foreseeable future.

In summary, a significant amount of the Office's work is reactive and advisory. Under these circumstances, the extent to which savings occur within program operations of the Commission corresponding savings may be available in the Office of General Counsel.

HEARINGS AND REPARATIONS (OFFICE OF THE EXECUTIVE DIRECTOR)

The Commission currently assigns 17 staff positions to the Hearings Section which has the responsibility for the initial adjudication of all reparations cases and administrative enforcement proceedings. It is the Commission's understanding that the NFA arbitration system is designed to complement existing exchange programs for arbitration of customer complaints, as well as provide an alternative forum for customers who might choose to arbitrate rather than bring their cases through the reparations process. The Commission understands, however, that NFA plans to implement all of its registration, surveillance, and membership programs before an arbitration system is developed. Thus, it is difficult for the Commission to predict with any degree of certainty the potential cost savings in this area because of the as yet unresolved questions relating both to when NFA's arbitration program will become operational and the extent to which that program will alleviate the Commission's current backlog of reparations cases. In addition, because the Hearings Section also handles enforcement cases, a function which would not be transferred to NFA, the Commission would need to retain a certain staffing level in the Hearings Section.

ADMINISTRATIVE SERVICES; PERSONNEL; OPERATIONS AND BUDGET (OFFICE OF THE EXECUTIVE DIRECTOR)

The Administrative Services Section will not be directly affected by NFA activities. Administrative Services, which has 22 employees, handles the internal management of the agency, including equipment, building maintenance, the mail, printing, paperwork management, etc. The demand for these services is likely to remain roughly the same, in the absence of substantial reductions in CFTC staff.

Personnel and Operations and Budget would also have roughly equal workloads, even with a reduction in staff. There would, however, be some savings in the Commission's expenditures for automated data processing ("ADP") by the transfer of the Commission's registration functions to NFA; registration, however, consumes only a small percentage of the total ADP requirement of the CFTC (one of 23 staff years).

The Commission believes that a fully-operational and successful NFA would allow the Commission to perform those functions which have remained within the scope of its responsibilities without increases in its present staffing levels and, correspondingly, without any growth in the size of these support offices.

DIVISION OF ECONOMICS AND EDUCATION

The Commission's understanding of proposed NFA functions and operations is that the NFA will take over few of the responsibilities currently performed by the Division of Economics and Education. In fact, the NFA has explicitly stated that it will not perform the market surveillance functions currently performed by the Commission. NFA will not become involved in enforcement of Commission or exchange speculative limits, nor will it operate a large trader reporting system at this time. (If NFA were to receive and process all of the Commission's large trader reports, the Commission could ultimately reduce its staffing level in this area by 17 staff years.) NFA will not, of course, have a role in the contract market designation process or in the review of exchange rules, the other primary responsibilities of the Division. Therefore, cost savings in the Division of Economics and Education that will result from the implementation of the regulatory functions currently envisioned by the NFA will be largely confined to a partial assumption of the Division's educative functions (the Commission anticipates a 60 percent reduction in the 2.5 staff years presently assigned to this task) unless NFA begins to collect large trader information for the Commission.

ENFORCEMENT

The NFA will investigate and prosecute its members who violate its rules through its Office of Compliance. The disciplinary system will be administered by the three Regional Business Conduct Committees and the Office of Compliance. This system will complement the exchange disciplinary scheme but will not abrogate the need for effective enforcement capabilities within the Commission itself. The penalties and remedies provided by the Act (e.g., monetary penalties of up to $100,000, injunctions and cease and desist orders, and the denial of trading privileges) are still necessary and must be sought by Commission enforcement personnel.

The NFA Compliance staff will relieve some of the burden on the Commission enforcement staff in the sense that disciplinary-type actions which will be eventually handled by the NFA currently clog the dockets of the Commission's investigators and trial attorneys. This does not necessarily mean, however, that positions can be eliminated in significant numbers. Rather, the Commission expects that NFA's compliance activities will function as a much-needed adjunct to the Commission's—and the States'—enforcement activities and allow the redeployment of the Commission's existing enforcement resources.

In connection with this discussion of NFA, the Commission would like to clarify some of the issues relating to its user fee proposal. Like the fees the Commission now collects for registrations and the fees collected by the Securities and Exchange Commission, the fees would be paid to the United States Treasury; the fee is not a substitute for the normal appropriations process. In addition, the Commission has recommended what is, in essence, a two-tiered fee: each exchange would pay either 6 cents or 12 cents "per side"—that is, the fee would be charged on both buy and sell orders—on each futures contract or option executed on the exchange. The actual fee, however, would depend upon whether the trade was for the account of a member of the exchange or of NFA (in which case the 6-cent rate would apply) or for the account of a person who was neither a member of the exchange or of NFA (in which case 12 cents per contract would be charged).

The Commission's recommendation includes that six-cent differential precisely because the Commission recognized that members of NFA and of the exchanges will be paying some of the costs of self-regulation. Indeed, the Commission suggested a reduced fee level for members of self-regulatory organizations such as NFA so as not to inhibit the growth of that organization and to help its members defray the costs of membership.

I am, on behalf of the Commission, pleased to submit this information for the hearing record. Copies of this letter are being jointly transmitted to the other ranking members of the Subcommittee and Committee and to Senator Dole.

Sincerely,

PHILIP MCBRIDE JOHNSON, *Chairman.*

[The following questions were submitted by Senators Lugar and Helms:]

COMMODITY FUTURES TRADING COMMISSION,
Washington, D.C., March 19, 1982.

Hon. RICHARD G. LUGAR,
Chairman, Subcommittee on Agricultural Research, and General Legislation, Committee on Agriculture, Russell Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: This is in response to your letter of March 4th requesting information and/or the Commission's views on a number of points raised during the hearings held before your subcommittee on the reauthorization legislation for the Commodity Futures Trading Commission, S. 2109.

Question 1. "What is the Commission's view of the NFA's proposal to preclude the CFTC from operation of its reparations system with respect to all registrants, except floor brokers, as soon as the NFA's system of uniform national arbitration is in force?"

Response. As we understand the NFA proposal, the Commission would be permitted to suspend its reparations system for claims against these commodity professionals as soon as a uniform national arbitration system, to be administered by NFA, is in place. Under a companion proposal the NFA would amend existing Section 17(b)(10) of the Act, which now requires a futures association to have rules under which a customer may voluntarily seek arbitration for claims up to $15,000 against association members, with a provision requiring that the rules of the association provide a uniform national system to settle disputes between members of the association and their public customers regardless of the size of the claim.

The Commission recognizes the benefits of arbitration and appreciates that the reparations system requires a substantial expenditure of Commission resources and can be improved. In an effort to reduce the number of reparations cases, the Commission has recently proposed amendments to its arbitration rules which would permit a customer voluntarily to sign a pre-dispute arbitration agreement to resolve claims under which he would waive his right to utilize the reparations forum. Similarly, in its proposed amendments to the Commodity Exchange Act the Commission has recommended that the reparations provisions be modified to enable the Commission to fashion rules to deal with claims more expeditiously and, as under the NFA proposal; that the dollar limitation for customer claims in Section 17(b)(10) be eliminated. Nevertheless, the Commission has some concern over aspects of the NFA proposal.

The Commission has consistently taken the position that, under the Commodity Exchange Act, a customer has an election of remedies against a commodity professional—a voluntary arbitration, the reparations procedures established under Section 14, and an implied right of action in federal courts for damages. The Commission has always understood these three remedies to be complementary so that a customer could pursue his claim in the forum of his choice. The Commission certainly hopes that the arbitration procedures of the NFA prove to be a viable alternative for customers. A national and uniform system should encourage the objective. However, the Commission believes that a customer should, if he so chooses, still be able to pursue his claim in reparations. Accordingly, the Commission would not object to the NFA proposal if it were made clear that (1) the suspension of the reparations system would apply only to those customers who have voluntarily agreed to have their claims arbitrated by the NFA or some other futures association and (2) there were rules in place that would assure that the customer could adjudicate those claims in the uniform arbitration forum.

With respect to this last point, the NFA proposal raises certain constitutional issues that are presently the subject of litigation. As indicated above, the Commission believes that any suspension of the reparations system should occur only if a person complaining of a violation of any provision of the Act or a Commission regulation could obtain an adjudication of his complaint in the uniform national arbitration system. This presupposes that the arbitration system will be a meaningful alternative for the customer. However, there is some question whether this will in fact prove true.

In an analogous area, the Commission has interpreted the contract market arbitration provisions of Secton 5a(11) of the Act to require a member or employee of an exchange against whom a customer has a claim to arbitrate that claim if the customer wished to do so. (A similar interpretation should apply to futures association arbitration under the similar provision in existing Section 17). The Commission's interpretation is based on the fact that both these Sections of the Act expressly provide that the use of the arbitration procedure by the customer is voluntary while no similar reference to voluntary participation is made for the member of the contract market or the futures association. Both Sections of the Act also now provide that there shall be no compulsory payment in the arbitration procedure unless agreed to by the parties. The Commission has construed this latter provision to refer to counterclaims, and as part of its proposed amendments to the Commodity Exchange Act, has suggested that Congress eliminate this provision so as to assure the binding nature of any award rendered on counterclaims. See Sections 14 and 24 of S. 2109.

Relying upon its interpretation of Section 5a(11) the Commission recently disapproved the rules of one contract market and required the exchange to adopt a rule that a member or employee of the contract market must arbitrate at the behest of the customer. You should be aware, however, that the exchange has taken the position that the Commision's interpretation unconstitutionally deprives the member or employee of his right to jury trial protected by the Seventh Amendment to the Constitution and has challenged the Commission's action affecting its rules. *Board of Trade of the City of Chicago* v. *Commodity Futures Trading Commission,* No. 81-C-7175 (McMillen, J.). Although the Commission argued that its interpretation was consistent with the language and purposes of Section 5a(11), the court agreed with the exchange and entered an order declaring the Commission's interpretation regarding the mandatory arbitration requirement to have violated the Seventh Amendment right to jury trial of members of the exchange.[1] Under the court's order the Board of Trade is to submit its proposed findings by Friday, March 12, 1982, with the Commission having the right to reply by Friday, March 19, 1982 and a hearing before the District Court on Monday, March 29, 1982.

The Commission is concerned that if the court's ruling in this case is ultimately sustained, it could affect the NFA proposal to the extent it assumes that a customer's claim could be adjudicated in the NFA arbitration forum. Should the NFA proposal be interpreted to require its members to arbitrate at the request of a customer or should the NFA adopt rules to that effect, a member of the NFA could argue, as the Board of Trade has argued, that such a requirement is unconstitutional. Should that position prevail, a customer would not be able to secure relief in the NFA arbitration forum and, in view of the suspension of the reparations system, would also be unable to seek relief before the Commission. To prevent such a possibility, the Commission believes that access to reparations should not be limited at this time but, if your Committee were to view the NFA proposal favorably, the language of the proposal or the Committee report should make clear that the reparations system would remain available for any claim that the customer is unable to pursue in NFA arbitration.

Question 2. "What is the Commission's view of the NFA's proposed amendment to the Act which would prohibit state and local governments from imposing transaction and related taxes on commodity futures transactions and options?"

Response. We understand that the NFA's proposal would prohibit state and local taxes on, or on the execution of, any transaction—including any services rendered directly in effecting such transaction or execution—involving futures contracts on designated exchanges or an option to purchase or sell any commodity or any futures contract regulated under Section 4c of the Act. The Commission appreciates the interest of the states in taxing business activity which may occur within their borders. Nevertheless, state taxation on futures or options trading could have serious economic consequences. Exchange trading serves as an important adjunct to national and international commerce. Dissemination of exchange prices facilitates the production, sale and movement of commodities throughout the world. A scheme of taxation could adversely affect market liquidity and thus undercut this important economic service performed by the exchanges. Moreover, even if state taxes are not viewed as the first step toward regulation of trading, they could make U.S. exchanges less competitive by driving trading to exchanges located in countries with more hospitable tax treatment. Accordingly, the Commission believes your Committee should support the NFA proposal.

---

[1] You should also be aware that the reparations procedure itself has been the subject of constitutional attack on similar grounds. One Court of Appeals has indicated and a second Court of Appeals has recently held that Section 14 does not violate the Seventh Amendment, *Rosenthal* v. *Bagley,* 581 F.2d 1248 (7th Cir. 1978), *Myron* v. *Hauser,* No. 80-1954 (8th Cir.).

Question 3. "How would the Commission view an amendment to Section 5a(8) of the Commodity Exchange Act codifying CFTC Regulation 1.53?"

Response. The Commission's legislative package incorporates an amendment to Section 5a(8) which would codify Commission regulation 1.53 and would require contract markets to enforce their rules.

Question 4. "An industry group, as well as the Commission, has suggested changes in the Commission's authority to approve exchange rules. We would appreciate your addressing the following issues related to exchange rules:

(a) "Testimony has been received that the Commission's proposal extends its rule review authority to a new, undefined type of rule "of major economic significance." In contrast, the Commission has claimed, in the section-by-section analysis of its legislative proposal, that this amendment would "reduce the types of contract market rules which require prior approval of the Commission before they may be implemented." Could you explain why, in the Commission's view, the amendments it has proposed will reduce the regulatory burden on the Commission and the exchanges?"

Response. Currently, Section 5a(12) of the Act requires the Commission to approve all proposed contract market rules "which relate to terms and conditions in contracts of sale to be executed on or subject to the rules of such contract market or relate to other trading requirements except those relating to the setting of levels of margin." The Commission's legislative proposal recommends limiting mandatory prior Commission approval of rule proposals to those rules which relate to terms and conditions of contracts or which would be of major economic significance, thereby deleting the mandatory prior Commission approval of rules relating to "trading requirements." Moreover, the Commission would be given explicit authority to define by rule those aspects of a contract which will be viewed as relating to terms and conditions of the designated contract.

With respect to the category of rules which would be of major economic significance, it has been the Commission's experience under existing Section 5a(12) that rules which it determines to be of major economic significance (for purposes of publication) typically are contract terms and conditions, with only a small percentage of rules relating to trading requirements being viewed as involving issues of major economic significance; e.g., recent exchange proposals to substantially increase clearing association guaranty fund contributions. Accordingly, the Commission believes that its proposal will permit a large percentage of exchange rules relating to trading requirements—currently subject to prior approval—to become effective without such prior approval, reserving to the Commission only the authority within ten days of the submission of such rules to determine whether they raise significant issues requiring Commission review.

Question 4(b). "Would the Commission object to deletion of the requirement for Federal Register publication of notice of all rules of major economic significance?"

Response. The Commission's legislative package recommends that Section 5a(12) be amended to require publication of a short, descriptive notice in lieu of the existing requirement that it publish the entire text of proposed rules which are of major economic significance. The Commission believes its proposal would eliminate the burdens and delays currently associated with publication but preserve the benefits, in an informal rulemaking context, of soliciting the views of all persons who may have an interest in the proposed contract market rule changes. In this regard, the Commission notes that certain industry groups have sought greater assurance of notice of proposed contract market rule changes which may affect their interests. Accordingly, absent some other effective means to assure general notice of exchange rule proposals which are of major economic significance, the Commission believes the publication of short, descriptive notices of such rules in the Federal Register strikes an appropriate balance between the burdens of any such publication and the benefits of providing an opportunity for input from all potentially interested persons. Of course, the full text of the proposed rules will be provided to members of the public upon request.

Question 4(c). "Witnesses at the hearings testified that while the Commission may follow the letter of the law with respect to Section 5a(12), some exchange rules have languished several years at the CFTC. The testimony is that the Commission often, if not routinely, avails itself of the statutory exception to the existing thirty or sixty day time limits on exchange rule reviews by notifying the exchanges of its inability to make such determinations. How would the Commission's proposal meet this objective?"

Response. The Commission first must note that the most significant factor influencing the time that it has taken to review many rule proposals is the exchange's submission of rule proposals which offer no explanation of their impact upon trading, the rights and obligations of market participants, possible anticompetitive effects, or adverse views within the exchange or among market users concerning the proposed rules. In these instances, it has been necessary for the Commission's staff to seek further information necessary to formulate informed recommendations to the Commission concerning such rule proposals and necessary to the Commission's review of the proposals. On many occasions, exchanges have delayed in responding to such requests for information or provided inadequate responses which have required repeated inquiries by the Commission's staff. Thus, on these occasions, the Commission's use of the exceptions to the statutory review periods is caused not by Commission delay, but by the exchange's failure to provide an adequate basis or reasons for approval of its rule proposal.

The Commission's proposal will assist in reducing the time required to review exchange rule proposals by reducing the overall number of rule proposals which require Commission approval before their implementation. The Commission's proposal will reduce the staff time devoted to preparing recommendations to the Commission concerning such rules, thereby permitting the Commission and its staff to more effectively focus their attention on the smaller number of rule proposals which raise significant issues under the Act. With the current amount of resources brought to bear on a small number of significant rule proposals, the Commission believes that, with the cooperation of the exchanges in submitting proposals which meet the procedural requirements of Commission regulation 1.41(b), it can assure the resolution of issues raised by such rule proposals within reasonable time periods.

Question 4(d). "What is the Commission's opinion of an amendment to Section 5a(12) which would require the Commission, in disapproving an exchange rule, to specify the section or sections of the Act or regulations violated by the disapproved rule?"

Response. To date, the Commission has disapproved rules under Section 5a(12) in only two instances. In both cases the Commission cited specific sections of the Act and of the Commission's regulations which it determined were violated by the contract market rules. The Commission believes that an amendment to Section 5a(12) which explicitly required such specification is unnecessary.

Question 4(e). "Does the Commission object to providing an exchange whose rule has been disapproved with a hearing on the record? Does an exchange presently have a right of appeal to the federal courts if the Commission disapproves its rule?"

Response. During the 1978 reauthorization process, a proposal to require a hearing "on the record" was rejected by the Congress in these cases. A hearing "on the record" means a full-scale trial, with rights of cross-examination. The Commission continues to oppose any requirement that its disapproval of an exchange rule under Section 5a(12) be undertaken pursuant to procedures requiring an "on the record" hearing. In a rule disapproval proceeding, no license is denied, no one is found to have violated the law and no remedial sanctions are imposed (these are the type of agency actions which ordinarily require an adjudicatory or on-the-record hearing). Rather, in disapproving an exchange rule under Section 5a(12), the Commission determines only that a particular rule does not comport with the provisions of the Act, may have anticompetitive implications that are not outweighed by the purposes of the Act served by the rule or otherwise is inconsistent with the provisions of the Act. These are matters of broad policy. Again, I should point out that, since its inception, the Commission has disapproved rules under Section 5a(12) on only two occasions.

Proposals to require an on the record hearing under Section 5a(12) were made to Congress in 1978 and were appropriately rejected. See "Hearings on H.R. 10285 Before the Subcommittee on Conservation and Credit of the House Committee on Agriculture," 95th Cong., 2d Sess. 282, 334, 460, 463, and 309 (1978); "Hearings on the Reauthorization of the Commodity Futures Trading Commission (S. 2391) Before the Subcommittee on Agricultural Research and General Legislation of the Senate Committee on Agriculture, Nutrition, and Forestry," 95th Cong., 2d Sess. Part II, 445, 452, 504, 606, 608 and 663 (1978). The Commission objected to these changes in the law, stating in particular that its actions under Section 5a(12) were in the nature of rulemaking and therefore adjudicatory or formal rulemaking procedures were inappropriate. As then Chairman of the Commission, William T. Bagley, testified:

"The act's very basic requirement that we approve, disapprove, or change any of the exchange rules is rulemaking, that is legislative. That is policy." 1978 House Hearings at 591.

Congress concurred in the Commission's judgment. As this Committee explained:

"The committee concluded that the imposition of a requirement for a hearing on the record for rulemaking procedures by the Commission would be extremely burdensome and would not avail the Commission of any information that it is not currently receiving in these proceedings." S. Rep. No. 850, 95th Cong., 2d Sess. 29 (1978).

This Committee's concerns retain their validity today. At a time when the Commission has taken internal steps to expedite its rule review process, and is proposing further legislative improvements, it would be anomolous to impose a right to trial that would only add to delay in the review process.

With respect to the second part of your question, a contract market whose rule has been disapproved may challenge the Commission's action in federal court, under the provisions of the Administrative Procedure Act. For example, when the Commission disapproved three trading rules of the Commodity Exchange, Inc., in April 1981, the exchange filed an action in federal district court seeking declaratory and injunctive relief to prevent the Commission from enforcing its disapproval of the rules. The exchange asserted that the Commission's determination was arbitrary, capricious, and an abuse of discretion. On June 17, 1981, the exchange applied for a preliminary injunction. On June 23, 1981, the court heard argument and denied the preliminary injunctive relief sought by the exchange. Presently, pending before the court is the exchange's Motion for Summary Judgment and the Commission's Cross-Motion for Summary Judgment. *Commodity Exchange, Inc.* v. *Commodity Futures Trading Commission*, No. 81 Civ. 3698, United States District Court for the Southern District of New York.

Question 4(f). "An industry group has proposed specific time limits (60 days for approval/disapproval, 180 additional days to complete disapproval proceedings) for the CFTC's review of exchange rules. Your testimony highlighted the complexity of proposed rules and the need for managerial flexibility. The Committee would welcome any suggestions you might have on any means short of a statutory amendment which would assure timely consideration by the Commission of exchange rule changes.

Response. As noted in the Commission's response to question 4(c), the most significant factor causing delay in the Commission's review of exchange rule proposals is the submission by the exchanges themselves of rule proposals which provide the Commission with an inadequate basis for approval and the exchanges' delays in responding to requests for information which would provide the Commission with information necessary to proceeding with its review. Accordingly, the Commission's first suggestion for reducing delay in the review period would be for continued efforts by the exchanges to improve the quality of submissions presented to the Commission.

The Commission also recognizes, however, that its internal administrative procedures may offer additional opportunities to expedite the rule review process. In this regard, the Commission's staff last fall implemented a number of procedural reforms designed to reduce delays resulting from sequential staff review of many rule proposals. These steps plus increased managerial attention to the rule review process already have resulted in continued improvements in the Commission's rule review process and expedited review of many rule proposals. The Commission also intends to consider further administrative measures designed to streamline the review process. Those steps will include delegation to staff of the Commission's authority to approve routine rule proposals, further reductions where possible of sequential review procedures among staff units, and expanded use of existing means of permitting rule proposals to become effective without prior Commission approval.

Question 5. "Please list the contract market designations currently pending before the CFTC, including any which are currently scheduled for Commission consideration."

Response. In response to question 5 above, please review attachment A to this letter.

Question 6. "Please furnish, by contract, for the period January 1, 1981, to the present, the date of each contract approval action taken by the Commission, the date on which each approved contract was submitted to the Commission and the date on which each such contract was listed for trading. In addition, please furnish, by contract, for the period January 1, 1981, to the present, the date on which any contract application was withdrawn."

Response. In response to question 6 above, please review attachment B to this letter.

Question 7. "What difficulties, if any, would the Commission encounter with a one-year time limit on the consideration of a proposed futures contract?

Response. While a one-year time limit on the consideration of proposed futures contracts would be sufficient in some instances, such as for the review of contracts similar to proposals already approved, it would greatly reduce the Commission's ability to assure that new types of contracts are in compliance with the Commodity Exchange Act.

A time limit is also not appropriate for the contract market designation process because of a number of unpredictable elements that are beyond the control of the Commission. First, the number of applications for contract market designation fluctuates widely from year to year. For example, the number of applications rose from 19 in fiscal year 1979 to 30 in 1980, and then declined to 20 in 1981. The peak backlog of 52 pending applications at the Commission in March 1981 was primarily the result of the large number of applications filed in fiscal year 1980. In addition, new concepts in futures trading are sometimes proposed, such as trading in stock indexes, that require unusual and unpredictable amounts of time to analyze policy issues and, in some cases, to work with other federal agencies.

Special problems also arise in cases where the proposed designation or designations being reviewed by the Commission are those of a new exchange not previously designated as a contract market. In such instances (e.g., the recent initial designations of the New York Futures Exchange and the New Orleans Commodity Exchange), initial designation requires not only review of the specific contract terms and conditions, but also review and approval of contract market rules establishing, among other things, membership requirements, financial rules, trading rules, disciplinary procedures, and an arbitration mechanism. Moreover, review of the exchange's rule enforcement capabilities, including programs for market, financial and trade practice surveillance, is required by Commission regulations 1.51 and 1.52 and Commission Guideline No. 2.

Moreover, the contract market designation process for a particular application is often extended over an unusually long period of time because of inadequate justification provided in an exchange's initial submission to the Commission. Even though the Commission has provided guidelines to the exchanges with regard to the requirements for applications, the review of the submissions by the Commission's staff often results in many questions that must be answered by the exchanges or the staff before the designation process can proceed. In many cases, an exchange response to such questions includes revisions of proposed contract terms, which then require further staff analysis.

As a practical matter, staff resources for reviewing new contracts are relatively inflexible. When staff resources are budgeted, the number of potential applications is unknown. Shifting staff resources from other areas to handle an unexpectedly large number of applications may not be feasible because of other high-priority projects.

Considering the Commission's limited staff resources and all of the workload factors that are beyond the control of the Commission, a one-year time limit on the consideration of proposed futures contracts could result in the approval of many contracts that would not meet the requirements of the Act if approval were to be automatic at the end of that time period. As an alternative to allowing automatic approval to occur, the Commission might be forced to institute proceedings to deny designation, which would be counter-productive and would consume an inordinate amount of staff resources.

Question 8. Response forthcoming.

Question 9. "We understand that the Chicago Board of Trade raised over $13 million from its transaction fee in 1981. Could you tell us what the level of the fee is and whether any group or groups of traders were then or are now exempt from paying it?"

Response. The Chicago Board of Trade ("CBT") assesses $.02 per contract ($.04 per round turn) for trades made for exchange members and $.50 per contract ($1.00 per round turn) for trades made for non-member customers. Specifically, CBT rule 450.00 provides for the payment, by exchange members and member firms, of $.02 "per side for each contract (1) for such member's own account; (2) for such member firm's account; and (3) executed by such member . . . as a floor broker . . ." Rule 450.00, however, limits the maximum annual payment by any member to $10,000 for categories (1) and (3). By contrast, the rule provides for a $.50 assessment per contract bought, sold or delivered for a non-member customer.

Rule 450.00 also requires the CBT's Board of Directors to determine the amount of revenues to be raised each year for educational and market and product development programs and when that amount has been collected, to suspend the collection of member transaction fees and one-half of the non-member fee. Accordingly, on October 8, 1981, the CBT waived its member fees and reduced the non-member fee to $.25 per side ($.50 per round turn), effective as of October 1, 1981 through the end of the year. In addition, in an effort to stimulate trading in the domestic certificate of deposit futures contract, the CBT has suspended, from August 1981 through June 1982, the collection of the non-member fee for trades in that contract. The CBT received $13,115,000 in transaction fees in 1981.

The Board of Trade Clearing Corporation ("BOTCC") separately charges a clearing fee of $.05 per contract ($.10 per round turn), irrespective of whether or not the trade was made for a member or a non-member of the CBT. BOTCC clearing fees totaled more than $4.9 million in 1981.

Question 10. "What is the Commission's view of the industry recommendation to remove the anti-speculative bias from the language of the Act?"

Response. The Commission believes that speculative activity in futures markets can contribute to market liquidity and usefulness of the markets for risk shifting by commercial interests and reaffirmed this view in the Federal Register notice accompanying its final rules which require exchanges to establish limits for all futures markets.

Section 4a of the Act, which authorizes the Commission to establish speculative limits, merely addresses "excessive speculation" which may constitute a burden on interstate commerce. Accordingly, limits maintained by the Commission under this section of the Act, or established by the exchanges under the Commission's new Regulation 1.61 are not intended to control speculation per se. Instead they limit the total size of speculative positions which can be maintained by a particular individual or group of individuals acting in concert and which may be detrimental to the proper functioning of the market.

On the other hand, the Commission has no objection to the deletion of nonsubstantive words or phrases that might be construed as pejorative as to moderate speculation, provided that no impairment of the Commission's powers results.

Question 11. "What difficulties, if any, would the Commission encounter if:

"(a) Exchanges were given initial responsibility to establish speculative position limits for all futures contracts; and (b) the statute required the Commission, when directing an exchange to establish limits, to make a finding that such limits were necessary to prevent manipulation, corners or squeezes?"

Response. Under the Commission's new regulation 1.61, contract markets have already been given the initial responsibility for establishing speculative limits in the numerous cases where limits have not previously been imposed by the federal government. Accordingly, the Commission sees no substantive difficulty with this manner of ensuring that speculative limits are in effect for each market. Nevertheless, to underscore the importance that the Commission attaches to regulation 1.61, the Commission has proposed a new Section 4a(5) to the Act, which specifically confirms the authority of the contract market to set speculative limits and would make violations of those limits an offense under the Act as well as under exchange rules. In this way, both the exchanges and the Commission would be expressly empowered to compel adherence to speculative limits (see Section 4 of S.2109).

Commission regulation 1.61 is pedicated on several different sections of the Commodity Exchange Act which pertain to orderly markets and the terms "manipulation, corners or squeezes" refer to only one class of market disruption which the limits established under this rule are intended to diminish or prevent. For instance, Section 4a of the Commodity Exchange Act contains the Congressional finding that excessive speculation in the futures markets can cause sudden or unreasonable fluctuations or unwarranted changes in the price of commodities. Accordingly, a requirement that the Commission make the suggested finding concerning "manipulation, corners, or squeezes" prior to requiring a contract market to establish speculative limits could significantly restrict the application of the current rule and undermine its more comprehensive regulatory purpose of preventing excessive speculation which arises from extraordinarily large positions.

Question 12. "Several commentators have recommended that the Act be amended to recognize explicitly a private right of action. While we are aware that the Commission is awaiting a determination by the Supreme Court, there is some concern that such a decision may come very late in the legislative process. Does the Commission have any plans to propose legislative language, in the absence of Supreme

Court action, before Committee markup or Senate floor action on the reauthorization bill has been completed?"

Response. You are correct that in view of the cases presently pending before the Supreme Court, in which the Commission has supported the concept of a private right of action, the Commission has not offered any legislative proposals in this area. However, the Commission appreciates your concern that the Court's decision may come very late in the legislative process. Accordingly, in an answer to a related question from Senator Boren concerning GAO's draft proposals, the Commission has expressed the view that Congress should address the subject of private rights of action and expressly declare that persons may sue for damages in federal court for violations of the Act committed by commodity professionals and, under certain circumstances, by the exchanges.

Accordingly, the Commission would support legislation that would expressly provide for private damage actions in federal court against:

(1) Any individual, firm or other person, whether or not registered or required to be registered with the Commission, who violates any provision of the Act or who aids or abets the violation or who conspires in a violation by another person and,

(2) Any contract market or other board of trade licensed by the Commission for a violation of a provision of the Act, except that a contract market or licensed board of trade should not be subject to private rights of action alleging only that it failed to perform a self-regulatory duty set forth in the Act unless it is alleged that the failure was committed to assist the violator or was motivated by self-interest among its Board of Governors or responsible Committee.

Question 13. "Suggestions have been made to require Commission registrants (except floor brokers) to register with states under their Blue Sky laws. An alternate recommendation is that the Commission notify state authorities of pending applications and obtain from the states any information which they may have bearing on the applicant's fitness. Procedurally, this practice would be similar to the Commission's current arrangements with the SEC and FBI. Would the Commission comment on both of these recommendations?"

Response. The Commission does not believe that the commodities industry would be better policed if a second registration requirement at the state level were imposed on Commission registrants. We believe that such a requirement would be duplicative and cumbersome without materially furthering either of the two main regulatory purposes of registration, which are (1) identifying who is in the industry and (2) excluding the unfit.

As for the first purpose, state officials currently have access to our registration information and are welcome to use it to determine whether persons in commodity businesses within their state are properly registered with the CFTC, or for other law enforcement purposes. When the revamping of our data processing system is completed, our registration staff will be able to mechanically sort registration information by state, thereby further facilitating response to state registration inquiries.

A state registration requirement also would not necessarily advance the second purpose of registration, that is, excluding the unfit. The CFTC background check, which includes a name check with the FBI and the SEC, and which will include verification by fingerprinting after July, should identify all cases in which there are state convictions or where state securities sanctions (which are reported voluntarily to the SEC) already have been imposed. The FBI records also should include state arrests and indictments voluntarily reported to the FBI by the states. Thus, the CFTC should not be registering persons that the states may be able to exclude. Nor would a state registration requirement in any way increase CFTC access to state information on pending cases.

In response to the second part of the question, a requirement that the CFTC notify state authorities of pending applications would appear to be of marginal benefit, at best, in producing additional information about applicants' fitness not already contained in and checked via FBI and SEC records. Registration denials ordinarily must be based on convictions or final administrative determinations, rather than solely upon charges or suspicions. Accordingly, information other than that relating specifically to convictions or administrative findings would be of limited use. A requirement that the Commission contact state authorities in all relevant states with respect to each of the 1000 or 1500 applications we process each month would probably yield very little data of benefit in protecting the public from unfit persons, and any such benefit would be far outweighed by the likely cost of and time consumed by such an endeavor. As a practical matter, the recommended procedure would substantially delay the registration process which now takes six to eight weeks, without promising materially improved results.

Question 14. "To what extent, if any, does registration of a person with the CFTC as a commodity trading advisor affect the ability of state law enforcement authorities to proceed against such a person for fraudulent conduct?"

Response. The present Commodity Exchange Act offers no immunity from state law enforcement simply because a person registers as a commodity trading advisor or, for that matter, in any other registrable category. Under Section 6d of the Act, for example, state law enforcement officials are free to file actions in federal court to seek injunctive relief or damages on behalf of their residents for violations of the Commodity Exchange Act and Commission regulations, including the provision in Section 4o of the Act proscribing fraudulent conduct by commodity trading advisors. In addition, Section 6d(7) of the Act expressly acknowledges the right of state law enforcement authorities to proceed in state court for violations of state general civil or criminal fraud statutes. Thus there are existing tools by which the states may proceed against commodity trading advisors registered with the Commission who commit fraud.

In addition, Commission amendments to Sections 8 and 12 of the Act proposed in S. 2109 should substantially facilitate law enforcement actions by the states. Under the amendment to Section 8, the Commission will be authorized expressly to provide confidential information to the states, such as the details of specific business transactions and the names of customers, for law enforcement purposes. In addition, under Section 12(e) of the Act, the "open season" provision, any state law, general or otherwise, may be applied against those commodity trading advisors or other industry professionals who are not registered with the Commission as required by law.

Question 15. "In the Commission's view, what would be the effect of extending the authority of state enforcement officials to apply state commodity or security antifraud laws against registered futures commission merchants, registered commodity pool operators, registered commodity trading advisors and registered associated persons of such registrants?"

Response. The Commission supports and has recently undertaken a special campaign to assist the efforts of the states to prosecute wrongdoing by those who operate at the periphery of the commodities industry. For example the Commission has communicated with every state's Attorney General, has prepared and distributed to scores of law enforcement officials a "Spotter's Guide" for their use in detecting fraudulent schemes, and will soon conduct a seminar for State law enforcement officials. And, as I noted in my answer to question 14, the Commodity Exchange Act presently recognizes the importance of state law enforcement and the Commission has proposed additional amendments to the Act to encourage the states to increase these efforts.

Nevertheless, a fundamental principle of the Commodity Exchange Act is to insure a uniform and comprehensive scheme of regulation of the legitimate commodity industry subject to the oversight of the Commission. The effect of permitting the states to apply the antifraud provisions of their regulatory commodity or securities statutes to Commission registrants could undercut this most basic tenet of federal regulation. Under such a proposal, for example, one or more states could make it a fraudulent practice for registered industry professionals to fail to comply with a variety of local regulatory requirements. These requirements might very well be in addition to and more burdensome than those which the Commission has prescribed. The Commission believes it would be inconsistent with the Act's regulatory scheme to permit the states to regulate the activities of those businessmen who comply with the provisions of the Commodity Exchange Act and Commission rules and are therefore entitled to rely upon the protections from duplicative regulation which the exclusive jurisdiction provision was designed to afford them.

I hope you find this information of assistance as you continue to review the Commodity Exchange Act.

Sincerely,

PHILIP MCBRIDE JOHNSON, *Chairman.*

Attachments.

ATTACHMENT A

APPLICATIONS PENDING COMMISSION APPROVAL BY YEAR OF SUBMISSION AND COMMODITY GROUP AS OF MARCH 10, 1982—TOTAL 37

Submission	Agricultural	Stock indices	Interest rates	Natural resources
[illegible]9			MACE 90-day T-bill	
1980		CBT Index Portfolio (11), CME S&P Stock Index, COMEX 500 Stock Index.	CBT 90-day T-bill, CME 6-month T-bill.	CBT Gulf Coast heating oil.
1981	MACE refined sugar	NYFE Equity Stock (Indices (5)).	CBT intermediate term T-Note, NYFE 25-year corporate bond.	MACE gold coins, CME gold coins, CBT gold coins, CBT Gulf Coast unleaded gas, CBT Gulf Coast leaded gas, COMEX gold coins, MACE silver (N.Y.).
1982			KCBT 90-day T-bill, CBT prime rate.	CBT crude petroleum, CME Gulf Coast unleaded gas, CME Gulf Coast leaded gas.

ATTACHMENT B-1

Exchange	Contract	Date submitted	Date of Commission approval	Trading began
NOCE	Milled rice	Nov. 15, 1976	Feb. 12, 1981	Apr. 9, 1981.
NOCE	Rough rice	do	Apr. 8, 1981	Apr. 10, 1981.
NOCE	Cotton	Feb. 11, 1977	June 30, 1981	July 7, 1981.
NOCE	Soybeans	Mar. 20, 1977	Oct. 27, 1981	Oct. 29, 1981.
KCBT	Value line average	June 15, 1979	Feb. 16, 1982	Feb. 24, 1982.
CME	Italian lira	Sept. 4, 1979	Sept. 30, 1981	
CBT	Long-term T-note	Oct. 17, 1979	Sept. 23, 1981	
CBT	Short-term T-Note	do	Sept. 30, 1981	
NYME	New York Harbor unleaded gas	Dec. 27, 1979	Sept. 1, 1981	
NYME	New York harbor leaded gas	do	do	Oct. 5, 1981.
CBT	Domestic CD	Dec. 28, 1979	July 21, 1981	July 22, 1981.
NYME	Gulf Coast heating oil	Jan. 3, 1980	Aug. 4, 1981	Aug. 17, 1981.
CBT	Eurodollars	Jan. 10, 1980	Dec. 15, 1981	
CBT	Sunflowers	Jan. 28, 1980	Nov. 24, 1981	
CME	Domestic CD	Apr. 14, 1980	July 28, 1981	July 29, 1981.
CME	Eurodollars	do	Dec. 8, 1981	Dec. 9, 1981.
NYFE	GNMA–CD	May 30, 1980	Sept. 23, 1981	
NYFE	Domestic CD	July 3, 1980	June 30, 1981	July 9, 1981.
CME	Plywood	Aug. 19, 1980		July 28, 1981.
MACE	15-year T-bond	Sept. 4, 1980	Sept. 9, 1981	Sept. 18, 1981.
NYFE	Eurodollars	Feb. 5, 1981	Dec. 15, 1981	
NYME	Gulf Coast unleaded gas	May 26, 1981	Oct. 27, 1981	
NYME	Gulf Coast leaded gas	do	do	Dec. 14, 1981.

ATTACHMENT B-2

6. CONTRACT MARKET DESIGNATION APPLICATIONS WITHDRAWN

Exchange	Contract	Date withdrawn
CBT	Cotton	Nov. 19, 1981.
CME	20-year T-bond	Dec. 9, 1981.
CBT	Southern plywood	Dec. 15, 1981.
Comex	One-year T-bill	Dec. 28, 1981.

[Additional questions submitted by Senator Lugar:]

COMMODITY FUTURES TRADING COMMISSION,
Washington, D.C., April 14, 1982.

Hon. RICHARD G. LUGAR,
Chairman, Subcommittee on Agricultural Research and General Legislation, Committee on Agriculture, Nutrition, and Forestry, Washington, D.C.

DEAR MR. CHAIRMAN: It is a pleasure to respond further to questions regarding issues in the Commodity Futures Trading Commission reauthorization process. Please note that answers to questions 16, 17, 18, and 19, from your letter of March 4, 1982, follow immediately. Thereafter begin our answers to your questions forwarded by letter dated March 15, 1982.

Question 16. "To what extent, if any, are foreign governments' marketing agencies using U.S. commodity futures markets?"

Response. There are approximately 15 marketing agencies for foreign governments that have or do use U.S. futures markets in a variety of commodities. Some of these agencies are consistent users of U.S. futures markets, while others only use the markets occasionally. These agencies are most prevalent in the markets involving commodities produced outside of the U.S., such as coffee "C" and sugar No. 11 contracts. They have been less significant in other futures markets such as those involving domestically produced commodities like grain.

These agencies have, for the most part, had relatively small futures positions. A review of foreign government trading during 1978 and 1979, for example, revealed that, with the exception of the sugar market, the maximum aggregate government positions in the various markets did not, at any one time, exceed 7 percent of the open interest in any one market. The sugar market had the highest incidence of trading by foreign governments, and their aggregate positions at one point amounted to 16 percent of the total open interest.

Question 17. "What impact, if any, does the activity on the part of these agencies have on U.S. commodity futures markets and on U.S. cash commodity markets?"

Response. Given the relatively small market shares held by marketing agencies of foreign governments, the Commission does not believe their participation in U.S. futures markets has had a significant impact on those markets. U.S. commodity markets, both cash and futures, are sensitive to developments in the international markets for those commodities. Since exports are a major demand component for many agricultural commodities, the sales activities of competing suppliers will affect domestic prices regardless of whether those buyers hedge in U.S. futures markets.

Question 18. "Does the Commission undertake any oversight activities aimed specifically at observing the activities of foreign government marketing agencies in the commodity futures markets? Does the Commission or any other government agency have any special registration or reporting requirements applicable to these marketing agencies? If there are none, does the Commission believe such reporting requirements would be desirable?"

Response. The Commission has certain reporting requirements that apply to all traders, foreign and domestic. If a trader has a reportable position in any market, the trader's identity and futures positions are required to be reported to the Commission by the trader's futures commission merchant or foreign broker. The trader is then required to file a Commission identification form, CFTC Form 40. Through this form the Commission can identify accounts of foreign governments.

These accounts are then subject to CFTC surveillance in the same manner as all other traders. They are monitored for any indications that they may be engaging in an effort to manipulate futures prices. If the Commission believes a foreign government is involved in any manipulative activities or any other major market disturbance, the Commission is prepared to take the appropriate measures to prevent the manipulation or market disruption. Our experience to date, however, has not indicated the need for special requirements regarding foreign government participation in these markets.

For the most part, the Commission has not experienced problems with foreign government agency participation in U.S. futures markets. In many instances, representatives of these agencies met with Commission staff prior to using the market to acquaint themselves with CFTC regulations and to assure the Commission they would not be a disruptive influence in the futures market.

The only problems the Commission has had with the futures trading of agencies of foreign governments was in the coffee futures market in the late 1970s. The Commission had reason to believe that certain coffee producing countries were attempting to use the coffee futures market to raise or stabilize the cash price of coffee. Since such activities would constitute price manipulation under the Commodity Exchange Act, the Commission took a number of actions to deal with that problem, including issuing a market emergency order. An investigation of the market resulted in an administrative complaint charging two agencies of coffee producing countries with violations of the Commodity Exchange Act.

Question 19. "What position, if any, does the Commission have regarding the announced intentions of the Australian wheat board to expand their use of U.S. commodity futures markets?"

Response. The Commission views the U.S. grain futures markets as international markets that reflect global supply and demand conditions for those commodities. Accordingly, the Commission places no special restrictions on the use of these futures markets by foreign traders or the marketing agencies of foreign governments. Those foreign entities must, however, comply with the same regulatory requirements, including reporting requirements and compliance with Commission speculative limit rules, as any other market participant.

In the 1980/81 marketing year, the United States exported 41 million metric tons of wheat. These large exports accounted for over 60 percent of total U.S. production that year, and 42 percent of total world wheat exports. These statistics demonstrate the major role of exports in the marketing of the U.S. wheat crop and the major influence of international supply and demand conditions in the determination of the price of wheat on all U.S. markets, cash and futures.

Because of the importance of U.S. participation in international commerce in wheat and other grains, the U.S. futures markets have long been used by international grain merchants, foreign grain buyers and processors, and the marketing agencies of foreign governments. Our experience to date has been that agencies of foreign governments have not carried significant positions in these markets that would warrant special regulatory treatment. They are, of course, subject to CFTC surveillance.

Question 1. "Please describe the sales and other abuses perpetrated by 'agents of futures commission merchants' mentioned in your earlier testimony and how the Commission's proposal would deal with these abuses."

Response. Agents of futures commission merchants ("FCMs") serve the same functions in regard to customer accounts carried by FCMs as do associated persons ("APs") operating out of branch offices of FCMs. Agents of an FCM receive customer funds in the name of the FCM, provide risk disclosure, provide advice with respect to commodity trading and transmit orders to the FCM for execution. The FCM profits from relationships with agents in the same way it profits from the activities of its APs in branch offices; it charges commissions on trades and may receive interest on customer funds on deposit. Agents have the opportunity to commit the same abuses as an AP of the FCM. An agent may convert customer funds, fail to provide risk disclosure, provide false or misleading information to induce a customer to trade and intentionally mishandle customer orders in a variety of ways [for the benefit of the agent]. The Commission's proposal would create uniformity in the registration status of all persons who solicit accounts and trades for the FCM whether denominated as "agents" or "APs." It is also intended to remove any appearance of ambiguity from the Act so that an FCM cannot disclaim responsibility for the acts of agents or try to assert that the agent is solely liable for its violations of the Act or regulations, in obtaining customers for the FCM.

Question 2. "Some witnesses have testified that the futures commission merchant is often the agent of the class of entities known as 'agents of futures commission merchants.' Please provide any data or information available to the Commission showing (1) the number of 'agents' who are, in fact, agents of futures commission merchants, and (2) the number of 'agents' who, in fact, use the futures commission merchants as their agents. Please report any recent growth in either of these categories."

Response. There has been a significant increase in the number of designated agents. There were 630 agents as of November, 1979; as of March 1982, there are approximately 1,000 entities designated as agents of futures commission merchants.

There is no specific data or information available for the Commission to categorize the activities of designated agents. We believe that about 10 percent of the designated agents are registered as "Introducing Brokers" in the securities industry.

We do not ascribe to the view that FCMs themselves actually are "agents" of these persons. All accounts originating with these persons are carried on the books of the FCMs as the FCMs' own customers. All account statements, margin calls, trade confirmations and other documents sent to customers bear the FCM's name, not that of the soliciting person. As a result customers typically assume that they are doing business with the FCM and that the soliciting person is merely a convenient conduit.

Question 3. "What additional responsibilities and liabilities would futures commission merchants be required to assume if these 'agents' were registered as associated persons of the futures commission merchants?"

Response. As indicated in response to question 1, the Commission's view is that the proposed registration of agents as APs would not impose any additional responsibilities and liabilities on FCMs which they do not now have with respect to persons who handle customer accounts of the FCM. (See Section 2(a)(1) of the Act, generally making firms liable for the acts of their agents.) However, some FCMs have fought to assert that agents have a different status than other persons who act in the same capacity for the FCM, based upon the separate treatment of agents in Section 4k of the Act. The Commission's proposal is intended to make it clear that all persons who solicit customer business for an FCM are the responsibility of the FCM. The FCM must appropriately supervise such persons and would be liable for the actions of such persons when such actions violate pertinent laws or regulations.

Question 4. "The American Bar Association Committee on Commodities Regulation and others have proposed that 'agents of futures commission merchants' be regulated as 'introducing brokers.' Is this a viable alternative? If the 'introducing broker' proposal were enacted, could the Commission establish net capital requirements for 'introducing brokers' by regulation, giving due regard to their need to be able to conduct business and the public's need to deal only with financially viable 'introducing brokers'?"

Response. Of course, the regulation of agents as introducing brokers is preferable to continuing their present essentially unregulated status, but is an inferior approach to the proposal of the Commission. If such a registration category were established, the Commission could, unless statutorily barred, establish net capital requirements for such brokers by regulation. Ideally, any statutory change requiring the registration of agents as introducing brokers would also include language similar to that of Section 4f(2) of the Act which expressly prohibits registration of an FCM that does not meet the minimum financial requirements established by Commission regulation.

The Commission, however, has proposed that agents of futures commission merchants be regulated as associated persons and has rejected the introducing broker concept. This proposal is based upon an analysis of (1) the composition of the agent community, (2) the functions performed by agents for the FCMs with which they deal, and (3) how the "consumer" perceives these functions.

As of March 18, 1981 the agent community was composed of 843 agents, 15 percent (123) of whom were registered as APs, 45 percent (382) of whom were registered with the Commission in at least one capacity, and 55 percent of whom were not registered. On September 30, 1981, of the total (383) of registered FCMs 100 (26 percent) FCMs used agents, and of these 39 (10 percent of the total) accounted for 80 percent (672) of the agents so used. Thus, only about ¼ of the total number of FCMS would be affected by a change in the regulation of agents, and only 10 percent would be substantially affected. Further, only about half of the agent population would be affected by a new registration requirement.

While agents are not lawfully permitted to receive customer money except in the name of the FCM, they do accept orders or accounts on behalf of an FCM. As such, they function in the same manner as an AP employed directly by an FCM or working for an FCM in a branch office. Because of the apparent relationship between an agent and the FCM in whose name the agent accepts the customer money it receives, Commission experience is that the normal expectation of a customer who deals with an agent is that the named FCM has some accountability for that agent's acts or omissions. The Commission has concluded, therefore, that the Act should make clear that FCMs that deal through agents and those which deal through branch offices have the same responsibility for the manner in which sales personnel are supervised and customer accounts are procured. In this connection, it should be noted that some agents, themselves, employ APs, and at present, that these APs may not be supervised by the related FCMs. (When the Commission's sponsorship rules become effective in July, such APs will clearly be the responsibility of a sponsoring FCM.) Of the 2305 APs employed by agents, however, 1922 were employed by only 39 agents—that is 4 percent of the agents employed 83 percent of APs. Over half of the agents therefore apparently had no APs and were presumably individual operators.

The Commission believes it would be anomalous to create two different types of regulatory schemes for persons or combinations of persons performing the same functions. Where such persons are individuals, this is particularly clear; in fact many of the individual agents may already be registered as APs. In the case of firms acting as agents, the introducing broker concept might be more useful. If such a broker category is established, however, the problem of responsibility for supervising the practices of such brokers within the industry will be resolved in favor of supervision (not by exchanges, or by other firms as is the case of APs or of member firms) but by the CFTC using its resources. Moreover, as you suggest, in order for such agents to be financially accountable for their obligations to customers and under the Act, net capital requirements might be necessary. If such requirements were applied to many of the "sole practitioner" agents who appear to constitute more than half of the agent population, however, functioning as an agent as a means of livelihood may no longer be practicable.

For these reasons the Commission has rejected the "introducing broker" concept as complicated to implement as well as inequitable to certain categories of persons now acting as agents, and to avoid establishing two categories of registration for registrants performing the same functions. The Commission further believes that the creation of an introducing broker category may be inadvisable. The obvious advantage to an FCM of having no responsibility for the sales practices of persons soliciting its accounts may encourage more FCMs to do business through such brokers as opposed to branch offices and APs.

Question 5. "Please comment on the testimony of certain witnesses to the effect that the proposed amendments to sections 4k(5) and 8a(2) of the Act are inconsistent. These witnesses point out that, under the first section, a futures commission merchant cannot permit a person subject to statutory disqualification to be associated with the futures commission merchant; while under Section 8a(2), the Commission may register a person subject to a statutory disqualification (e.g., conditional or restricted registration). If this inconsistency is substantive, please suggest statutory language or other means of resolving it."

Response. In attempting in Section 4k(5) to provide that a registrant could not employ a person whose background evidences facts which would be a statutory disqualification under Section 8a(2) where the Commission had not yet made a determination as to that person, we inadvertently neglected to account for the possible case where the Commission had made a determination to register such person conditionally or otherwise. We recommend that this oversight be remedied by adding, after the comma in Section 4k(5), the words: ", unless such registrant has notified the Commission of such facts and the Commission has determined that such person should be registered or temporarily licensed."

Section 4k(5) would then read, as follows: "(5) It shall be unlawful for any registrant to permit a person to become or remain an associated person of such registrant, if the registrant knew or should have known, of facts regarding such associated person that are set forth as statutory disqualifications in section 8a(2) of this Act, unless such registrant has notified the Commission of such facts and the Commission has determined that such person should be registered or temporarily licensed."

Question 6(a). "Are U. S. traders barred from making unsolicited purchases of options on foreign markets? Is any legislative clarification needed on this issue?"

Response. In the Commission's view, Section 4c(c) of the Act plainly bars U. S. traders from making purchases of options on foreign markets, regardless of whether the purchases are solicited, and no legislative clarification is required. Section 4c(c) bans not only solicitation of option purchases, but the very act of "enter[ing] into" a commodity option transaction. In 1976, with respect to the similar provision in Section 4c(a)(B) of the Act, banning option transactions with respect to those commodities specifically set forth in Section 2(a)(1) of the Act, the Commission stated:

> ". . . [I]t is clear that the application of the prohibitions contained in section 4c(a)(B) is unaffected by whether or not some activity related to the carrying out of an option transaction occurs outside the United States . . . A contrary interpretation would emasculate the decision of Congress to ban trading in the United States in options in those commodities specifically enumerated in section 2(a)(1) of the Act."

41 Fed. Reg. 26606 (June 28, 1976). The Commission believes a similar interpretation should apply to the 1978 ban on commodity option transactions set forth in Section 4c(c). Of course, the Commission has the authority to lift this ban in accordance

with the Congressional oversight procedures set forth in that Section, but would be hesitant to do so absent an effective method of regulation and sufficient resources to ensure that no solicitations are made, lest the types of abuses which occurred before the ban with respect to London options be repeated.

We believe the Commission's position is also consistent with other Congressional action taken in 1978. At that time Congress enacted Section 4c(d) to exempt certain dealer options on physical commodities from the Section 4c(c) ban. Congress expressly limited that exemption, however, to domestic firms, and gave the Commission authority to determine the conditions under which foreign dealer options could be sold in the United States. The Commission has stated that it "does not intend to exercise . . . casually" its authority to waive the ban against granting of dealer options by persons not domiciled in the United States. 43 Fed. Reg. 54223, n.8 (Nov. 21, 1978); see also, 46 Fed. Reg. 23476 (April 27, 1981).

Question 6(b). Answer will follow.

Question 7. Answer will follow.

Question 8. "Please provide an analysis of the legal basis for the Commission's proposal for the institution of user fees as contained in Section 27 of S.2109."

Response. Section 26 will require exchanges and certain other persons who trade instruments subject to the Commission's jurisdiction to pay an insubstantial fee generally designed to defray part of the cost of regulating those instruments. The fees are assessed in recognition of the fact that participants in the markets regulated by the Commission derive greater direct benefit from that regulation than the general tax payer. Similar provisions have been enacted by Congress in order to offset the expense attendant to the administration of other statutes. See, e.g., 15 U.S.C. § 77f(b) and 12 U.S.C. § 541. Of particular relevance is the user fee provision contained in Section 31 of the Securities Exchange Act of 1934, 15 U.S.C. § 78ee. That Section requires each national securities exchange to pay a yearly fee of one three-hundredths of one per centum of the aggregate dollar amount of the sales of securities transacted on that exchange during the preceding year and further requires each broker and dealer to pay an identical yearly fee on sales of listed securities which are transacted otherwise than on a national securities exchange. No payment is required where the yearly fee would be less than $100 or where the Securities and Exchange Commission, consistent with the standards set forth in Section 31, has granted an exemption.

The imposition of such fees clearly is a proper exercise of Congress' power under the United States Constitution. In this connection, the Supreme Court, while identifying limitations on the power of agencies to impose user fees under the Independent Office Appropriations Act, 31 U.S.C. § 483a, expressly observed that no limitations exist on Congress' power to require such payments directly by statute. See *National Cable Television Association, Inc.* v. *United States,* 415 U. S. 336, 340-341 (1974). *Cf. City of Pittsburgh* v. *Alco Parking Corp.* 417 U. S. 369; 373-374 (1974).

It bears emphasis that the issues before the Supreme Court in *Hill* v. *Wallace,* 259 U. S. 44 (1922), are not applicable here. In that case the Court held that a tax contained in the Futures Trading Act of 1921, on grain futures not executed on contract markets, was an invalid exercise of Congressional taxing power because the tax was designed to coerce compliance with the regulatory requirements of the statute. Here, no such coercive design exists. Moreover, in light of more recent precedent, it is questionable whether the limitations on Congressional power announced in *Hill* v. *Wallace,* supra, would be recognized today. See *Bob Jones University* v. Simon, 416 U. S. 725, 741 n.12 (1974) (wherein the Supreme Court stated the distinctions between regulatory and revenue-raising taxes established in cases such as *Hill* v. *Wallace,* supra, had subsequently been abandoned by the Court); see also *United States* v. *Sanchez,* 340 U. S. 42, 44-45 (1950) (substantial tax imposed on transfer of marijuana by registered persons held to be legitimate exercise of Congress' taxing power despite its collateral regulatory purpose and effect.)

Question 9. "Please give a brief description of the factual situations which led to the Commission's exercise of its emergency powers. For each situation, describe the nature and extent of the emergency action taken."

Response. The Commission has exercised its emergency powers on four occasions:

1. In the matter of the November 1976 Maine potato futures contract on the New York Mercantile Exchange

With only three trading days remaining in the November 1976 potato futures contract, there were 1,000 open positions in the contract. At that time, persons holding substantial long positions informed the Commission's staff that they intended to stand for delivery. Based on surveillance and other data, however, the Commission determined that there were too few railroad cars available to accomplish delivery for the number of outstanding open positions. The Commission therefore found a market emergency to exist.

In its emergency orders the Commission generally limited transactions in the contract to trading for liquidation only and required that margin on all open positions in the contract be increased to a level at least equal to the full market value of the futures contract. The Commission permitted the exchange to allow a trader to assume a new short position if the clearing member responsible for the short futures position could demonstrate to the satisfaction of the exchange that the new short trader could actually effect delivery of potatoes in accordance with the terms of the contract.

2. In the matter of the December 1977 coffee "C" futures contract traded on the New York Coffee and Sugar Exchange

In November 1977, the Commission ascertained that several traders held a substantial concentration of large long positions in the December Coffee "C" Future. These traders had, in previous futures, taken delivery of substantial quantities of coffee. The Commission's surveillance staff conducted a special survey to determine the availability of deliverable coffee for the December future. After reviewing the results of this survey and consulting with the New York Coffee and Sugar Exchange, the Commission and the Exchange both issued emergency orders. The Commission supported the Exchange's action with an order explaining that the Commission had reason to believe that there existed a threat of market manipulation or corner in the December 1977 Coffee "C" futures contract. The Commission also determined that the acts of a foreign government were affecting coffee trading, causing the market inaccurately to reflect the forces of supply and demand.

The Commission's order directed the Exchange to limit trading in the contract to liquidation only. The order also required the Exchange to direct and enforce a reduction of open interest in the contract in accordance with a schedule set forth in the Order. Finally, the Commission also directed the Exchange to proceed in accordance with the Exchange's own emergency resolution and to ensure the orderly liquidation of the contract.

3. In the matter of the March 1979 wheat futures contract traded on the Board of Trade of the city of Chicago

After several months of extensive surveillance of both market conditions and trading in the March 1979 wheat futures contract, the Commission developed the following surveillance information. A small number of speculative traders had established and were maintaining potentially dominant long open positions. Those traders were not reducing their positions. As a result the traders were holding an increasingly larger proportion of the total open interest as the last day of trading approached. The total open positions exceeded the amount of wheat available for delivery against the contract. Moreover, much of the available wheat was either unacceptable for delivery against the contract or owned by or committed to commercial users. These problems were compounded by a shortage of transportation facilities to bring wheat to the delivery point and a significant shortage of warehouse facilities. In addition, the Commission found a perceived distortion of price relationships between the contract and other values of wheat.

As a result, on March 15, 1979, the Commission issued an order stating that it: "has reason to believe that (a) a major market disturbance, which is preventing the market for wheat from accurately reflecting the forces of supply and demand, exists as a consequence of significant transportation and warehouse facility shortages, and (b) there exists a threatened manipulation or corner in wheat as a consequence of this disturbance and the combined long open positions presently being maintained in the contract by a small number of speculative traders."

The Commission therefore ordered the Chicago Board of Trade to suspend all trading in the contract for the following day, Friday, March 16. The Chicago Board of Trade complied with that order. Throughout that day, the Commission continued to assess the market situation and to communicate with Exchange officials. That evening, the Chicago Board of Trade advised the Commission that the exchange was declaring an emergency and would require that trading be limited to liquidation only, except new sales for delivery only.

Subsequently, that evening, the Commission issued a supplemental order stating that it continued to believe that an emergency existed. It ordered the Chicago Board of Trade to terminate all trading for the three remaining days in the contract, to permit deliveries of wheat in fulfillment of the current open positions at the price in effect as of the close of trade March 15, 1979, and to settle all positions in the contract which remained open as of March 30, 1979, at the March 15th price.

4. *In the matter of the wheat, corn, oats, soybean oil and soybean meal futures contracts traded on the Board of Trade of the city of Chicago, the MidAmerica Commodity Exchange, the Kansas City Board of Trade, and the Minneapolis Grain Exchange*

On Friday evening, January 4, 1980, President Jimmy Carter announced that sales of grain, technology and strategic materials to the Soviet Union would be sharply curtailed as a result of the Soviet Union's invasion of Afghanistan. The embargo potentially increased the domestically available supply of corn by approximately 12 million tons, the available supply of wheat by 4 million tons and the available supply of soybeans by 1 million tons. At the same time, the President announced that the federal government would shortly take action to minimize the effects of the embargo on the agricultural sector of the economy. The details of that action were not announced at the time the embargo was imposed.

The Commission immediately sought and obtained information from the Secretary of Agriculture, members of the Secretary's staff, major grain dealers, farm organizations and futures commission merchants. On Sunday, January 6, the Commission determined that the embargo, coupled with the uncertain nature of the Administration's plans to ameliorate the potential impact of the embargo, prevented the markets for the affected commodities from accurately reflecting the forces of supply and demand. In addition, the Commission believed that there existed the likelihood that orderly trading in related futures contracts could not be maintained. The Commission therefore declared a market emergency and directed that trading in these futures contracts be suspended for January 7 and 8.

Question 10. "Please identify and comment on the anticipated effects, if any, flowing from judicial review of the Commission's exercise of its emergency powers. What burden of proof would those seeking judicial review bear? What burden of proof or burden of coming forward with evidence would the Commission bear?"

Response. The potential and anticipated effects of judicial review of Commission emergency action generally break down into two areas. First, judicial review would, at a minimum, severely undermine the Commission's ability to accomplish the congressional purposes underlying Section 8a(9) of the Commodity Exchange Act. Second, any form of judicial review would inevitably create massive confusion in the affected futures contract or contracts thereby exacerbating an already difficult market situation.

Congress purpose in enacting Section 8a(9) is well documented. In 1974, Congress recognized that situations arise in futures markets which require immediate remedial measures. Congress also heard testimony that in these situations, an exchange might not agree with the Commission's view that an emergency existed or might otherwise be unwilling to take appropriate action. Two exchanges, trading the same commodity, similarly might disagree on these discretionary determinations. The exchanges' traditional emergency powers therefore could not be relied upon as the ultimate emergency action available. Congress also appreciated that government enforcement remedies are typically ineffective to deal with futures market emergencies. Congress thus vested authority in the Commission to determine whether a market emergency exists and the steps necessary to address the problem. In making these determinations, the economic and other factors to be considered and the relative weight to be accorded these factors were left by Congress solely to the "expert and impartial judgment" of the Commission (See S. Rep. No. 1194, 93d Cong., 2d Sess. 38 (1974) (Report of the Committee on Conference).

As the United States Court of Appeals for the Seventh Circuit found, "judicial review of the Commission's emergency determination would thwart the very purpose for which Congress authorized the emergency powers." *Board of Trade of the City of Chicago* v. *Commodity Futures Trading Commission,* 605 F.2d 1016, 1025 (7th Cir. 1979), cert. denied, 446 U. S. 928 (1980). In exercising its Section 8a(9) power, the Commission considers the broad public interests to be served by orderly futures trading, not only the private interests that may affect the judgment of an exchange or one group of traders. Under Section 8a(9), the Commission must also evaluate complex economic factors in order to determine, for example, whether there exists a "threatened" manipulation or circumstances which constitute a "major market disturbance which prevents the market from accurately reflecting the forces of supply and demand for . . . [a] commodity . . . " These concepts are outside normal judicial expertise or experience. Whether an emergency exists is simply not a question of fact, capable of verification by evidence which opposing parties may present to a court. Rather, it is a judgment to be made by weighing diverse economic and regulatory factors. And, the judgment is, of course, tempered by the Commission's unique experience in conducting surveillance of all future markets and its familiarity with the prior conduct of all major market participants. Thus, only the Commission can offer both an "expert and impartial" judgment in market emergencies.

Moreover, all of the factors involved in an emergency determination must be weighed in an often volatile trading situation and in the midst of a possible evolving market crisis. In these circumstances, timing is paramount. If the Commission were simultaneously required to prepare witnesses, elaborate court pleadings and documentation of each development in the trading of a particular contract, the Commission might either have to delay its action or take action too hastily in order to allow time for litigation. Either result would undermine the very purpose of the emergency authority.

The adverse market consequences of permitting judicial review are numerous. First, the mere fact of litigation over whether there is an emergency will undoubtedly inject non-economic factors into the daily trading decisions of the participants in the market. Trading decisions would be based on estimates of the outcome of the lawsuit, rather than the forces of supply and demand. Second, the Commission could be called upon to defend emergency actions in many different federal district courts at the same time. Long traders, short traders and the exchange involved in the emergency could bring separate actions challenging whether the Commission has adequate "reason to believe" an emergency exists. This could lead to conflicting court orders and massive confusion in the markets. Third, if the Commission determined tomorrow that a "threatened" manipulation existed, the traders involved in the scheme might convince a district court that there was some question whether there was a market emergency and thereby obtain a temporary stay of the Commission's order to preserve the status quo. The perpetrators would then be free to effectuate their scheme in the futures markets, while the court took the time necessary to both study the various factors forming the basis of the Commission's emergency action as well as whether it agreed with the Commission's assessment of the market. If a manipulation occurred in the interim, it could result in irreparable harm to innocent traders or others who relied upon the manipulated market price. The fact that the Commission could in time penalize the persons engaged in the manipulative scheme would not undo the damage to the integrity of the market or to honest market participants. Finally, if judicial review is permitted, courts will ultimately be conducting this review long after the emergency was declared. Indeed, in one case a Commission emergency order was challenged two years after the contract expired. No one can seriously maintain that it promotes order and integrity in futures markets for the possibility to exist that a court may declare void a Commission order which altered the rules of trading in a contract which has already expired.

The Commission has never suggested that it has been or should be placed above the law. The Commission did not argue, nor did the Court of Appeals for the Seventh Circuit hold in the Wheat case, that a Commission emergency action is immune from any form of judicial review. Both the Commission and the Court recognized that action committed to agency discretion—like that taken under Section 8a(9)—is judicially reviewable where the action is challenged on constitutional grounds or upon a claim that the agency has acted in bad faith or in a manner plainly repugnant to its statutory authority. In fact, the courts have treated Commission emergency orders in a manner similar to their treatment of emergency actions taken by the commodity exchanges themselves. While this limited form of review does not permit the court to substitute its judgment for that of the Commission on whether an emergency exists, it does ensure that the government will not act without any constraint. Indeed, the Commission continues to believe that the most effective review of the Commission's emergency power lies with those who conferred that power—the Congress. And Congress has effectively reviewed the Commission's exercise of its emergency authority. That oversight has demonstrated that the Commission has acted cautiously and judiciously in invoking its power. There is no justification, therefore, to provide for judicial review of agency determinations under Section 8a(9).

With regard to your questions relating to burden of proof, it is difficult to respond with a high degree of certainty since in the actions brought to date challenging the Commission emergency orders, judicial review has been held to be unavailable. See *Board of Trade of the City of Chicago* v. *Commodity Futures Trading Commission,* supra; Equitable Trust Co. v. *Commodity Futures Trading Commission* [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH). ¶ 20,902 (W.D. Tex. 1979). Assuming, contrary to this precedent, that some form of judicial review is permitted, the party challenging the Commission's action would likely have the burden of proving that the Commission's findings of an emergency was arbitrary and capricious, an abuse of discretion or otherwise not in accordance with law. See, e.g., *Camp* v. *Pitts,* 411 U.

S. 138, 142 (1973); *Nevada Airlines, Inc.* v. *Bond,* 662 F.2d 1017, 1020 (9th Cir. 1980). In other words, a party challenging a Commission emergency order would have to prove that the Commission's "determination was a clear error of judgment lacking any rational basis in fact" (ibid). Conversely, the Commission would have to argue that its emergency order did not reveal a "clear error of judgment."

Question 11. "What problem or situation does the Commission hope to remedy by enactment of the 'controlling person' provisions?"

Response. Enactment of a "controlling person" provision would provide the Commission with an additional theory of secondary liability under the Act. Currently, the only provisions of the Act which expressly impose secondary liability are Sections 2(a)(1) and 13(a) of the Act. Under Section 2(a)(1), a principal, usually a corporate entity or a partnership, is liable for the acts of its agent, usually an employee acting for the firm. This provision enables the Commission to proceed "upstream" against a business entity which is strictly liable for the acts of its employee. It fails, however, to provide a means of proceeding "downstream" and through the corporate veil against, for example, officers who may have failed to exercise their responsibilities to prevent the violation of the Act. This is particularly important in cases where there are involved per se violations by a firm, such as failure to register with the Commission, to meet capital requirements or to comply with requirements to segregate customer funds from those of the firm. Absent such a provision, a court may find there is no statutory basis for imposing liability on persons who were officers and controlling shareholders of a small firm which failed to properly segregate customer funds or to register with the Commission as a futures commission merchant. Thus, the individuals are free to form a new corporation and seek to register with the Commission. Because they have not been found by the court to have violated the Act, there is no express statutory basis upon which the Commission may seek to deny registration by the new firm.

Similarly, Section 13(a) of the Act, which proscribes willful aiding and abetting of violations, limits to some degree the Commission's ability to reach controlling persons. To require proof of willfulness where a controlling person is charged, for example, with having aided and abetted a firm's failure to segregate customer funds, may require the Commission to prove that the controlling person actively intended to divert the customers' funds. To ensure that the highest standards of care are observed in the commodities industry, the Commission should need only to show that the firm had the duty to segregate, failed to do so and that the controlling person knew or should have known of the facts and did not take the steps necessary to prevent the violation. Accordingly, under existing law a controlling person may escape liability completely. This loophole in the existing theories of liability in the Act may seriously disserve the public interest by permitting culpable persons to continue to operate in the commodities industry.

Question 12. "Is this proposed provision broader, narrower or approximately the same in scope as the provision in Section 20(a) of the Securities Exchange Act?"

Response. Like Section 20(a) of the Securities Exchange Act, 15 U.S.C. § 77t(a), proposed Section 13(b) of the Commodity Exchange Act would apply to any person "who, directly or indirectly, controls any person" who violates any provision of the applicable Act, or rules, regulations and orders thereunder. The major difference between the two provisions cited is the wording of the defenses they provide against "controlling person" liability.

Under Section 20(a) of the Securities Exchange Act, a controlling person can avoid liability by showing that he "acted in good faith and did not directly or indirectly induce the act or acts constituting this violation or cause of action." Under the Commission's proposal, avoidance of liability would be conditioned on showing that "the controlling person did not know or in the exercise of reasonable care, did not have reason to know" of the facts constituting the violation. This language was modeled on Section 15 of the Securities Act of 1933, 15 U.S.C. § 77o, which holds controlling persons harmless where they have "no knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist."

Despite the seeming difference in the two formulations, apparently due to the fact that both the 1933 Act and the 1934 Act controlling person defenses were enacted simultaneously,[1] the courts do not appear to have distinguished between the different statutory defenses.[2] The Commission believes that they are essentially equivalent in practice. For example, a supervisor who was not himself a direct or indirect participant in violative conduct, who lacked knowledge of the violation and who employed reasonable supervisory procedures, would successfully escape controlling person liability under either standard.

---

[1] Public Law No. 291, Title I, § 20 48 Stat. 899, and Title II, § 28, 48 Stat. 908 (June 6, 1934).

[2] See generally, *SEC* v. *Management Dynamics, Inc.*, 515 F.2d 801, 812 (2d Cir 1973). But see II Loss, Securities Regulation at 1747 (1961).

Question 13. "Please comment on whether the Commission arguably already has adequate tools to deal with problems in this area in light of:

(a) The attribution provision of Section 2(a)(1) of the Act; (b) the common law doctrines of respondeat superior and alter ego; and (c) the existing language in the proposed amendment to the aiding and abetting provision in Section 13 of the Act?"

Response. It is indisputable that the Commodity Exchange Act already contains certain theories of secondary liability. Section 2(a)(1) provides that "[t]he act, omission, or failure of any official, agent, or other person acting for any individual, association, partnership, corporation, or trust within the scope of his employment or office shall be deemed the act, omission, or failure or such individual, association, partnership, corporation, or trust, as well as of such official, agent, or other person." Under this provision a principal is liable for the employment related misdeeds of its agents. In accordance with the common law agency doctrine of "respondeat superior," a principal can be held to be strictly liable for the acts of an agent under certain circumstances.[3] The Commission is also theoretically free to assert that an individual is the alter ego of a corporation and, if the difficult proof is met, a court might pierce a corporate veil. It should be noted however, that a person can control corporate policies or operations without being a corporate alter ego.

Additionally, under Section 13(a) of the Act, individuals can be held liable as principals if they are found to have willfully aided and abetted the underlying violations. If the Commission's proposed amendment to Section 13(a) is adopted,[4] this provision will no longer be limited to administrative proceedings before the Commission, but will be explicitly available in all proceedings under the Act.

Despite the availability of the theories of secondary liability in the Act and at common law, the Commission believes that a "controlling person" provision is a necessary supplement to its existing powers. As explained in answer to question 11, under existing law, it is possible for individuals who may have failed to exercise their responsibility to prevent violations of the Act to be held to a lesser standard of care than the entity on which a statutory duty rests. It is possible, for example, for a person who is an officer, director and sole shareholder of a corporate FCM to negligently violate the Act's registration requirements or to carelessly violate segregation requirements, and, unless we are able to invest the time and resources needed to prove that he is the alter ego of the entity or that he willfully aided and abetted this violation,[5] he may escape liability. As a result, the Commission may obtain meaningless sanctions against a defunct corporation while the people who have caused its demise continue in the commodities business by assuming new corporate identities or acting as undisclosed principals in other firms.

Question 14. "Please cite any specific instances occurring in the last three years in which a potential defendant escaped prosecution because this proposed provision was not part of the Act."

Response. It is impossible to quantify the number of potential respondents who may have slipped through the Commission's enforcement net as a result of the fact that no "controlling person" provision is contained in the Act. A review of enforcement actions since 1979 reveals approximately six cases based on serious financial, reporting and recordkeeping violations in which no principals were charged. In several similar cases, individuals were charged with aiding and abetting their firms in such violations. Some of these cases have been settled or adjudicated; others are still in progress. However, in light of the Commission's recent holdings that "specific unlawful intent" is a necessary element of aiding and abetting,[6] absent a congressional clarification that a lesser standard of willfulness is sufficient, the Commission's ability to charge individuals with aiding and abetting "per se" violations of the Act will be diminished.[7]

---

[3] Section 219 of Restatement (Second) of Agency (1958) explains the doctrine of respondeat superior as follows.

"(1) A master is subject to liability for the torts of his servants committed while acting in the scope of their employment.

"(2) A master is not subject to liability for the torts of his servants acting outside the scope of their employment, unless:

"(a) The master intended the conduct or the consequences, or (b) the master was negligent or reckless, or (c) the conduct violated a nondelegable duty of the master, or (d) the servant purported to act or to speak on behalf of the principal and there was reliance upon apparent authority, or he was aided in accomplishing the tort by the existence of the agency relation.

See also Restatement (Second of Agency) §§ 261–262 (1958). Although respondeat superior liability has been imposed in cases arising under the Act, see, e.g., *Auditor* v. *Rosenthal & Co.*, Comm. Fut. L. Rep. (CCH) ¶ 20,658 (N.D. GA. 1978), this is not uniformly the case. See, e.g., *CFTC* v. *J. S. Love & Assoc. Options, Ltd.*, 422 F. Supp. 652 (S.D.N.Y. 1976).

[4] S. 2109, Section 21.

[5] In two recent opinions, the Commission was constrained to find that Congress, in enacting Section 13(a), intended that specific unlawful intent be shown before a person could be found to have willfully aided and abetted a violation of the Act. *In the Matter of Richardson Securities, Inc.*, 2 Comm. Fut. L. Rep. (CCH) ¶ 21,145 (January 27, 1981); *In the Matter of Earl K. Riley*, CFTC Doc. No. 80–15 (November 24, 1981).

Question 15. "Would the application of this provision be limited to civil proceedings or would it also be employed in criminal prosecutions brought under the criminal provisions of the Act?"

Response. It could be argued that section 9(c) of the Act establishes the basis for misdemeanor prosecutions against persons who control others who violate Sections 4a, 4c(a), 4e, 4i, 4k, 4m, 4o(2) or 8b of the Act. However, we believe that such persons could not be held criminally responsible, absent proof of a criminal intent to violate the law.

Question 16. "Could this proposed provision be employed as a vehicle to sue a controlling person in a private action filed under the Commodity Exchange Act?"

Response. Assuming that a private right of action is found to exist under the Commodity Exchange Act, a question which is currently pending before the Supreme Court, a private litigant would be able to bring suit against a "controlling person." A contrary result would be achieved only if the controlling person provision were explicitly limited to actions brought by the Commission.

Question 17. "Please review the ABA Committee on Commodities Regulation legislative proposals with a view toward determining which, if any, of these proposals might be integrated into the provisions of S. 2109."

Response. Much of the draft submitted by the ABA Committee on Commodities Regulation contains "essentially technical and editorial changes which are designed to make the Act easier to read and understand" (ABA draft, p. 3). While we welcome these efforts, we believe that these technical changes should be considered, as a whole, at a later time, so that Congress and the Commission may focus their attention on the important substantive issues which must be resolved in this reauthorization period. Some of these technical changes require careful analysis to assure that they will not have unintended substantive consequences, such as in the area of registration. Moreover, the purpose of these proposed changes, designed to make the Act as a whole easier to understand, would best be accomplished if they are considered after all substantive changes enacted in the reauthorization process have been incorporated into the Act. We noted that the ABA draft does contain some substantive proposals concerning commodity options, creation of a new category of "introducing brokers," commodity pools, and Commission exemptive powers which are addressed separably in this response (Questions 4, 6, 24, and 19 respectively).

Question 18. "Please provide a description of the reforms which the Commission plans to make in the reparations procedures if the provisions of Section 22 of S. 2109 are enacted."

Response. In addition to providing that the reparations forum would no longer be available to hear claims against persons who are not registered with the Commission, Section 22 would delete several of the complex procedural requirements presently contained in the Act and permit the Commission to redesign the reparations program through rulemaking. While the particular actions the Commission might take under this rulemaking power will be the subject of extensive study by the Commission should Section 22 be enacted, certain areas have already been identified in which improvements might be made. Thus, the bill provides that the Commission may, among other things, prescribe procedures concerning the form, filing and service of pleadings or orders, the nature and scope of discovery, counterclaims, motion practice and hearings (including the waiver thereof which may relate to the amount in controversy).

The Act currently provides that in reparations cases where the damages claimed do not exceed $5,000, a hearing is not required. Under the Commission's proposal (which eliminates this $5,000 provision) the Commission could raise the amounts in controversy necessary before a hearing need be held. Or, the Commission could require that in any case a hearing be held only with respect to matters in dispute, empowering its hearing officers to have the parties stipulate to other matters. Another example which the Commission could adopt to expedite claims would be to require complainants to effect service upon registrants rather than obliging the Commission to do so as is the case under current law. Such a procedure would be more consistent with the way cases are tried in the courts so that no claim would be heard if the complainant did not effect proper service. Another reform which might be adopted would enable Commission hearing officers to entertain motions to dismiss claims for failure of prosecution, dilatory tactics, or where the respondent is the subject of a bankruptcy or receivership proceeding. In addition, the Commission might determine that all decisions of its hearing officers would be final in certain classes of cases involving particular provisions of the Act and not others. For example, the Commission could limit the types of cases it might wish to consider or review to those involving more complex questions arising under the Act, such as manipulation and fraud. Less complex cases, such as damages flowing to a customer because a respondent did not provide a disclosure statement required by regulation might be exempted from the Commission's appellate process.

---

[6] *In the Matter of Richardson Securities, Inc.*, 2 Comm. Fut. L. Rep. (CCH) ¶ 21,145 (January 27, 1981); *In the Matter of Earl K. Riley*, CFTC Doc. No. 80–15 (November 24, 1981).

[7] In other contexts, it has been held that: "[I]f a person intentionally does an act which is prohibited, irrespective of evil motive or reliance on erroneous advice, or acts with careless disregard of statutory requirements, such an act is a willful violation of the Act." *In the Matter of Morris Auster*, Comm. Fut. L. Rep. (CCH) ¶ 21,095 at 24,411 (August 20, 1980), citing *Goodman* v. *Benson*, 286 F.2d 896,900 (7th Cir. 1961); *In the Matter of Carl M. Tipton, Jr.*, [1977-80 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,673 at 22,748 (1978).

While the foregoing are, of course, only illustrative of the reforms which could be made, we believe they clearly demonstrate the Commission's commitment to improve the reparations program so that it could provide the type of prompt resolution of claims that Congress intended.

Question 19. "The American Bar Association Committee on Commodities Regulation has recommended that the Act be amended to include a provision which permits the Commission to grant an exemption from any section of the Act. Would additional exemptive power improve the Commission's ability to carry out the purposes of the Act?"

Response. The Commission believes that its general rulemaking authority contained in Section 8a(5) of the Act is sufficiently broad to enable it to grant exemptions from statutory requirements when appropriate. For example, the Commission has previously exempted from the Act's registration requirements certain commodity trading advisors and commodity pool operators. (See 17 C.F.R. § 14.13-15 (1981).) Nevertheless, the Commission would support a provision such as that contained in the ABA draft (p. 36). Such expressed additional exemptive power would enhance the Commission's ability to target regulations to areas where they are needed most and also enable the Commission more effectively to utilize its resources in order to assure compliance with the law by those subject to those regulations.

Question 20. "You mentioned during the course of your testimony that the Commission would share with the subcommittee the comments it was filing in connection with the GAO report. We would appreciate receiving these comments for the record or any other comments you wish to make on the record concerning the GAO report."

Response. A copy is attached.

Question 21. "Would you comment on the GAO statement that the rule enforcement reviews of the Chicago Board of Trade and the Chicago Mercantile Exchange were completed in late 1980 or early 1981 and the Commission has not yet issued reports on these matters?"

Response. Any such statement is incorrect and, indeed, unsupported by the GAO's own draft report. Commission staff in mid-1981 provided GAO staff with preliminary staff drafts of reports concerning the rule enforcement activities of the Chicago Board of Trade ("CBT") and the Chicago Mercantile Exchange ("CME"). The Commission's staff emphasized at that time that the draft reports presented only preliminary findings and had not been reviewed by any of the Division's senior supervisory officials. Since the staff provided these initial draft reports to the GAO staff, it has completed its reviews of both the CBT's and CME's programs, reviews which evaluate the Exchanges' programs through the end of 1981. Throughout this period, the Commission's staff continually advised GAO staff of its progress toward completion of these reviews.

The rule enforcement review of the CBT is now scheduled to be considered by the Commission on April 20, while the review of the CME should be considered in May.

Question 22. "Based on any or all of the previous Commission studies of leverage transactions, please identify the general public interests, if any, which are served by regulating leverage transactions at the Federal level."

Response. Since Congress first vested the Commission with exclusive jurisdiction over certain leverage transactions in Section 217 of the Commodity Futures Trading Commission Act of 1974, several studies have been conducted to aid the Commission in determining how best to regulate these transactions. These have included a report on trading in leverage contracts in gold and silver (Project #217) prepared for the Commission in April 1975 under the auspices of the Department of Agriculture before the 1974 Act became effective, and the July 1976 report on forwards, futures and leverage contracts prepared by the Commission's Advisory Committee on the Definition and Regulation of Market Instruments. In addition, the Commission's staff has prepared analyses of issues involving the regulation of leverage transactions, including an April 1978 empirical study by the Division of Enforcement, a May 1978 economic evaluation by the Division of Economics and Education and a September 1978 review of the Act and its legislative history by the General Counsel's office. None of these studies, however, has specifically attempted to identify or analyze the general public interests that may be served by the regulation of these transactions at the Federal level as opposed to other regulatory approaches.

A discussion of this issue of which we are aware can be found in the testimony of Mr. M. Martin Rom, an official of a firm engaged in the sale of leverage transactions, to the Senate Committee on Agriculture and Forestry during its hearings on the 1974 legislation. Hearings on S. 2485, S. 2578 and H.R. 13113 before the Senate Committee on Agriculture, Nutrition and Forestry, 93d Cong., 2d Sess. 748-753 (1974). In his testimony to the Committee, Mr. Rom pointed out that his company as well as several others were then engaged in the business of selling leverage transactions, that these businesses were growing rapidly and that, at that time, this industry was not subject to any comprehensive federal regulation. In his testimony, Mr. Rom also indicated that a number of states had taken differing approaches to the regulation of leverage transactions as securities and otherwise, and that this was resulting in some "confusion" which, in his view, could best be remedied by vesting in a federal commission with expertise in commodities exclusive regulatory authority in the area. By subsequently enacting Section 217 of the 1974 Act, thereby providing for such a regulatory approach, it appears that Congress, at that time, may have agreed that federal regulation of leverage transactions was appropriate.

As you know, the Commission has suggested during this reauthorization process that certain amendments to be made to the Act's provisions dealing with leverage transactions. In particular, the Commission has suggested, among other things, that the Act be amended to require it to study and report to Congress within two years on various questions concerning leverage transactions including whether this form of business activity is imbued with a sufficient national public interest to warrant regulation solely by the Commission and, if so, what type of regulatory structure would be appropriate to protect the public. In light of the fact that no analysis has apparently been done to date concerning what national public interests may be fostered by federal regulation of leverage transactions, we feel that such a detailed, congressionally-mandated study would be an invaluable aid to both the Congress and the Commission in their joint efforts to find an appropriate approach to the regulation of these transactions.

Question 23. "Please provide a legal analysis of the constitutionality of action on the part of the Commission (a) refusing to register an applicant and (b) suspending a registrant's registration, both of which occur without opportunity for a hearing, for the reason stated in the proposed amendments to Section 8a, i.e. proposed section 8a(2)(B) through 8a(3)(H)."

Response. We assume that the thrust of your questions concerns whether the Commission's proposed amendments abridge the Due Process Clause of the Fifth Amendment to the Constitution of the United States. As you know, Congress has already authorized the Commission to deny registration without a hearing if a person has previously been found to be unfit for registration or is subject to an outstanding order under the Act imposing various other sanctions. See Sections 4n(5) and 8a(2)(A) of the Act. In order to achieve greater flexibility in the registration process, the Commission has proposed to broaden this existing authority to include suspensions and to list additional statutory disqualifications for prior violations of law. (Each of these statutory disqualifications is based upon a previous finding or order by the Commission, a court, or another governmental body.) Under the proposed amendments, the Commission would be authorized to deny or suspend registration "[u]pon notice, but without a hearing and pursuant to such rules, regulations, or orders as the Commission may adopt. . . ."

Since the absence of a statutory disqualification would be a pre-condition of registration, it would be doubtful whether any person who is covered by a statutory disqualification has an "entitlement" to registration or to continued registration sufficient to provide the affected person with an interest protected by the Due Process Clause. See e.g., *Board of Regents* v. *Roth,* 408 U. S. 564, 577 (1972).

In any event, even if a person who is subject to one of the statutory disqualifications has a protected interest, the proposed amendments do not contemplate governmental action without due process of law. The affected person would receive notice of the disqualification, and, while no new evidentiary hearing would be required to prove the violation a second time, the Commission will be authorized to develop appropriate procedures to ensure that the guarantee of the Due Process Clause is not abridged. This approach to licensing fully comports with the due process precepts established by the Supreme Court. The Court has often held that interests protected by due process, including licenses, may be suspended without affording any form of hearing. See, e.g., *Barry* v. *Barchi*, 443 U.S. 55, 64 (1979); *Dixon* v. *Love*, 431 U.S. 105 (1977). To be sure, the Court has explained that under the Due Process Clause " 'some form of hearing' is required before the owner is finally deprived of a protected property interest." *Logan* v. *Zimmerman Brush Co.*, 50 U.S.L.W. 4247, 4250 (Feb. 24, 1982), quoting from *Board of Regents* v. *Roth*, supra, 408 U.S. at 570–571, n.8 (emphasis in original). The Court has reiterated, however, that the timing and nature of the required hearing will depend on appropriate accommodation of the competing interests involved. These include the importance of the private interest and the length or finality of deprivation . . .; the likelihood of governmental error . . .; and the magnitude of the governmental interests involved . . ." *Logan* v. *Zimmerman Brush Co.*, supra, 50 U.S.L.W. at 4250–4251.

The Commission will, of course, be guided by these constitutional principles in promulgating the necessary regulations if its amendments to Section 8a(2) are enacted.

Question 24. Answer will follow.

Question 25. "The American Bar Association Committee on Commodities Regulation has recommended that the commodity pool be regulated as a separate entity and that a slightly different regulatory scheme be applied to the persons operating the pool. Please compare this proposed regulatory scheme with the one proposed in S. 2109 and comment on the viability and desirability of the ABA regulatory scheme."

Response. The Commission believes that the existing regulatory scheme is far preferable to the changes suggested by the American Bar Association Committee. The proposal for changing the manner in which commodity pools are currently regulated advanced by the American Bar Association Committee on Commodities Regulation has several elements, as follows:

1. Eliminates the definition of commodity pool operator and defines the "commodity pools" which will be regulated entities, eliminating certain small groups of persons, certain regulated investment companies, and any employee benefit plan subject to the Employee Retirement Income Security Act of 1974. (New Section 2(a)(1)(vii)).
2. Requires the registration as an associated person, of any partner, officer, employee or agent of a commodity pool who solicits or accepts a participant's or prospective participant's money, securities or property, places or monitors trading instructions, or supervises persons so engaged, unless registered with the Commission in some other capacity. (New Section 4k(2)).
3. Requires registration of commodity pools. (Revised Section 4m).
4. Eliminates statutory requirements for the registration applications of commodity pools and instead permits CFTC to require such information as may be necessary to determine whether applicant is qualified eliminating any reference to the public interest. (Revised Section 4n(1)).
5. Eliminates existing Sections 4n(5) and (6) of the Act concerning the denial of registration of commodity pool operators and trading advisors and incorporates similar provisions in Section 8a(2) where the other bases of denial of registration are contained.
6. Amends the anti-fraud provision pertaining to commodity pool operators to apply to commodity pools and any principal or associated person of a commodity pool. (Revised Section 4o).

S. 2109 contains some of the same or similar changes. For example:

1. S. 2109 requires partners, officers, employees, or agents of commodity pool operators who solicit funds for participants in commodity pools or supervise such persons to be registered as associated persons of the pool operator for which they perform these services. Exempts all other categories of registrants except CTAs from registering in this capacity and permits the CFTC to provide further exemptions by rule.
2. Eliminates Section 4n(5) and (6) and comparably augments Section 8a(2) of the Act.
3. Adds associated persons of CPOs to the anti-fraud provisions of Section 4o.

Consistent with the Congressional scheme presently set forth in the Act, S. 2109 continues to regulate the pool operator, and not the pool itself. Under the Commission's proposal, the pool operator is responsible for compliance with the Act and regulations thereunder. Under the ABA proposal, principals of the pool and the pool operator appear to be responsible only for fraud. In the case of a syndicate or a trust, there may thus be a question whether the persons responsible for the management of the trust or syndicate, e.g., the general partners or the trustee, could be held responsible for compliance with the Act and regulations.

At present the Commission registers pool operators and requires them to provide a disclosure document for each pool they operate which includes, among other things, disclosures as to the past performance of the operator. If each pool were independently registered, the past performance history of the operator (which the Commission views as vital to an analysis of any pool investment) may no longer be an appropriate regulatory requirement.

Moreover, registering the pool would be very similar to registering participations in the pool (as we understand is done by the SEC in the case of "public" pools). This aspect of the ABA proposal may create unanticipated problems in interpreting the SEC/CFTC accord as it pertains to commodity pools, since that accord was intended to reflect and confirm a status quo in which pool operators, not pools, were registered with the CFTC.

Finally, the ABA proposal would not define certain entities as pools. The Commission finds these exceptions too broad, especially as the expansion of institutional investment in commodities is so new. For example, the Act defines "person" to include entities. To exclude pools of less than 5 "persons" from the registration requirements of the Act could exclude pools made up of 5 corporate participants with substantial assets under management. Similarly, the ABA proposal would exclude all ERISA-regulated pension plans—this would encompass many very small plans which do not qualify for pension benefit insurance.

Should there arise need for further information we will be happy to obtain it for you.

Sincerely,

PHILIP MCBRIDE JOHNSON, *Chairman.*

Attachment.

COMMODITY FUTURES TRADING COMMISSION,
Washington D.C., March 8, 1982.

Hon. CHARLES A. BOWSHER,
Comptroller General of the United States, General Accounting Office, Washington, D.C.

DEAR MR. BOWSHER: Thank you for the opportunity to review the draft report prepared by your staff which was given to the CFTC on February 16, 1982. We appreciate the opportunity to comment on this draft. Our comments fall into two general categories: technical or factual errors and general comments on areas which we feel GAO should re-evaluate before the report is finalized.

After your report is completed, we will respond to you in detail on each of your findings and recommendations.

Before commenting on the specific parts of the report, we believe that it is important to place it in the context of the GAO analysis completed in 1978. At that time GAO found that "weaknesses in organization and management have hampered operations." Discussions which the GAO staff had with CFTC in preparation for this report indicate that management under Chairmen Seevers, Stone, and Johnson has been excellent, alleviating most of the concerns expressed in the 1978 report. The GAO staff has said that they did not refer to management in the report because they felt that the difficulties cited in 1978 have been resolved. The report should place its 1982 findings in the context of these discussions and make it clear that the recommendations are GAO suggestions for improvement in addition to the significant actions taken since the last GAO report.

A few other general observations are in order.

Over 30 actions recommended by GAO have already been adopted by the CFTC or are in progress.

The CFTC's reauthorization package, which was prepared prior to receiving GAO's draft report, addresses a substantial number of items discussed in the report, such as improved market surveillance, registration, and arbitration.

The report does not address how internal management improvements have enabled the CFTC to better use its limited resources.

Our specific comments on individual chapters are attached.

The Commission hopes that you will find these comments useful. We appreciate the cooperative working relationships which have existed in the conduct of this review, and we look forward to continuing to work with you on your recommendations.

Sincerely,

PHILIP MCBRIDE JOHNSON, *Chairman.*

Enclosures.

CHAPTER 1

1. Page 3, last paragraph, second sentence—It would be more accurate to say that the Commission was authorized through fiscal year 1978.

2. Page 4, first full paragraph, third sentence—The Chairman of the CFTC is appointed by the President, with the advice and consent of the Senate. See CEAct Section 2a(2)(B).

3. Page 4, last full paragraph—There are six major components: The Divisions of Enforcement, Economics and Education, and Trading and Markets, and the Offices of the Executive Director, General Counsel, and the Chairman. Support offices could be those either of the Chairman's Office or the Executive Director's Office.

CHAPTER 2

1. Page 7, first paragraph, second sentence—It would be more correct to say that no funding could be appropriated after September 30, 1982, absent reauthorization action by Congress.

2. Page 9, first paragraph, first sentence—Same comment as in Chapter 1, item 1.

CHAPTER 3

1. We feel that it is inappropriate to repeatedly ascribe the time lapse between contract submission and designation to weak management of our E&E Division (pages 23-26). In fact, the reasons for the timing of designations include: (a) the tremendous growth in new applications. If staff hours per contract were held constant and allocated total staff time were also constant, a hugh influx would necessarily slow output; (b) the need to answer questions posed internally and by other agencies of a fundamental and precedential nature about some of the new contracts. Once a threshold contract has been approved, others can follow quickly. During the GAO study period there were many threshold contracts filed; (c) during the period of the silver study, a substantial proportion of contract review personnel were assigned to that project and no contract reviews were completed during the first quarter of fiscal year 1981; and (d) an emphasis at the senior management level on self-regulatory and regulatory requirements, now in place, which were felt to be essential preconditions of a rapid increase in designations.

2. This chapter consistently refers to CFTC's "approval" of new contracts. The CFTC "designates" contract markets pursuant to requirements and procedures set forth in Sections 5 and 6 of the CEAct rather than approves them.

3. Page 12 should include that part of the designation review which requires that a contract not be conducive to price manipulation or distortion.

4. Page 15, third full paragraph, item (1)—If a term or condition does not conform to normal commercial practices, it must be shown why it is necessary or desirable. (See Guideline I.)

5. Pages 19 and 20—It should be pointed out that 1.50 reviews have not been made on a routine basis because of a management decision to give higher priority to new contracts and to limit 1.50 calls to cases in which the Commission believes there are significant deficiencies which represent potential market problems. In addition, in fiscal year 1981, the Commission did authorize 1.50 calls on 12 contract markets. Eleven of these calls became unnecessary because two of these designations were subsequently revoked and for the remainder, the exchange agreed to request and obtain Commission approval prior to listing additional trading months. The 1.50 review of cotton which was initiated by the Commission in fiscal year 1981 is continuing.

6. Page 22, third full paragraph, ninth line—CFTC did not propose to suspend trading in dormant contracts. This could only be done by formal Commission action (see Section 6b). The proposal would rather require the exchanges to receive CFTC approval under Section 5a(12) to restore trading in a dormant contract. This was also mentioned on page 32 in this chapter.

7. We would also note that the processing of new futures contracts accelerated substantially in the last half of 1981. As a result, twenty contract proposals were cleared in the July-December period, as compared with two such actions in the earlier period of 1981, reflecting basically a shift in emphasis in that period as well as

the relative absence of crises, such as the silver situation, which had consumed substantial staff time in the earlier period. While this development was known to GAO as well as to others, it is not even acknowledged in the draft report's discussion of new contract designations.

CHAPTER 4

1. Page 38, second full paragraph, first line—Change November 1981 to January 1, 1982.

2. Same sentence, second line—Change "daily" to "routinely" as '03 reports were required only when a reportable trader's position changed.

3. Page 39, first and second paragraphs—These are not correct as written. The '01 and '03 reports collect essentially duplicate data. Prior to the 1970s, series '03 reports were adequate for surveillance purposes because of the physical proximity of the largest of the traders in New York and Chicago. This insured that the bulk of the reported information was timely, and futures trading volume was low enough that futures trading data could be expeditiously handled by the Commission's predecessor agency. However, as trading volume increased, the locations of traders decentralized. As the trends in growth and decentralization continued, the '01 reports filed by FCMs gradually replaced the '03 reports as the major reports used for surveillance. The '01 reports were received in a more timely fashion than the '03 reports (hand delivered daily by the FCMs vs. mailed in by individual traders). Moreover, as the series '03 reports came to be filed by less experienced, less professional traders, they became increasingly less accurate.

4. Page 39, third paragraph, first line—"January 1981" should be "January 1982."

5. Page 40, footnote 3—Under CFTC's new reporting regulations, hedgers and speculators will be replaced with a commercial, non-commercial classification. The footnote should be corrected to reflect this change.

6. Page 43, last two sentences of the first partial paragraph—We are uncertain as to this reference. Recent ADP hires have been in Washington. The '03 changes are being done in Chicago by ADP programmers who have been with CFTC over 2 years.

7. Page 43, last paragraph—Add a sentence "The ADP Section is currently designing programs to enter cash prices into the system."

8. Page 44, second paragraph, last full line—Change "... data have not been developed ..." to "... data are just now being developed ..."

9. Page 44, paragraphs three and four—These two paragraphs are very confusing and misleading. The suggestions relate to timing and should be clarified.

10. Page 52, second full paragraph, first line—Add a "to" between "needs" and "improve."

CHAPTER 5

The Commission has already taken steps to implement almost all of GAO's recommendations with respect to the Commission's registration function.

CHAPTERS 6 AND 7

The Division of Trading and Markets has provided the Commission with extensive comments on Chapters 6 and 7 of the draft report, which are attached hereto. Those comments address serious inaccuracies in the draft report's description of the Commission's auditing and rule enforcement review programs. Accordingly, the Commission requests that any publication of its comments fully include the attachment and that the GAO amend its report to reflect the comments expressed by the Division of Trading and Markets.

CHAPTER 8

1. Page 125, first paragraph—We disagree that the reparation process is slow because the Chief ALJ (1) does not immediately assign complaints to presiding officers and (2) has not developed any standards which would encourage the presiding officers to maintain high productivity. While both of these areas may lead to improved production, it is unfair to blame them for a slowdown since each judge has an extensive docket of enforcement and reparations cases and the Chief ALJ reviews their caseload and production on a periodic basis.

2. In this same paragraph we would also like you to reconsider the statement that the agency has not designated a qualified staff member to answer the parties' legal and procedural questions. Each ALJ has a clerk to answer questions about cases on the judge's docket and a person in the Chief ALJ's office provides information to

parties whose cases are pending assignment with the Chief ALJ. On unassigned reparations cases, the Hearing Clerk provides status information. Additional steps are being taken to insure that these staff members are adequately responsive.

3. The statistics in this chapter do not consider the large number of cases stayed by the Commission or cases stayed by the courts due to bankruptcy and receiverships. The report should reflect these items.

4. The statistics also do not take into account the qualitative factor in reparations, i.e., the complex issues which cases often present which can only be resolved by careful study and analysis. Although these complex issues may take time to decide initially, the decisions save time in the long-run by clarifying legal and marketplace issues.

5. Page 139—There are discrepancies between GAO statistics and CFTC statistics concerning cases pending before the Commission. Apparently, GAO has defined "disposition" of a case as including only orders denying review and full opinions. However, the Commission does issue other types of orders which dispatch cases. CFTC statistics show 91 cases pending at the end of 1981.

6. The GAO Report states at page 151 that "the CFTC has taken little action to ensure that the exchanges have arbitration programs that meet legislative and agency requirements." This statement does not recognize that since the Commission adopted Part 180 of its regulations, it has received, reviewed, and approved complete arbitration rules packages from all eleven exchanges currently designated as contract markets. GAO also concludes that the Commission should conduct rule enforcement reviews of all exchange arbitration programs before proceeding with proposed amendments to Part 180. While the Division of Trading and Markets believes that reviews of each exchange's arbitration performance may be appropriate, such reviews are not essential to proceeding with the proposed amendments to Part 180.

First, rule enforcement reviews are not the primary means by which the Commission maintains its awareness of how exchange arbitration responsibilities are performed. For example, as a basis for proposing amendments to Part 180, the Division contacted several exchanges to determine the actual procedures by which they operate. Staff worked closely with those exchanges in order to become familiar with their systems, documentation, and statistics concerning use of their procedures. Second, the Division intends to scrutinize the comments received from the exchanges and other interested persons and take them into consideration when recommending Commission adoption of the final amendments. Those comments may also be helpful in guiding the development of an arbitration system by the NFA.

CHAPTER 9

Page 171—ADP Steering Committee—During an October 1981 meeting, the Executive Director informed the GAO staff that once the new ADP staff was in place the Steering Committee would be revived. At the time of GAO's interview with the new ADP Director, he was not aware of the Steering Committee plans as this was early in his tenure. However, discussions had been held regarding the Steering Committee by ADP staff with the Executive Director prior to December 31, 1981. Action was deferred until the new ADP team was on board and had charted a new direction.

AUDIT AND FINANCIAL REVIEW (CHAPTER VI)

THE COMMISSION SHOULD REDUCE THE NUMBER OF AUDITS OF MEMBER FCMS AND RELY INSTEAD UPON THE EXCHANGES TO BE THE PRIMARY MONITORS OF MEMBER FCMS

The Commission does not believe that excessive resources have been devoted to auditing member FCMs. As the draft report points out, the Commission needs to conduct certain audits of member FCMs not only to evaluate the performance of the exchange audit programs but to monitor compliance with the Commission segregation and recordkeeping regulations. Experience has shown that periodic visits to member FCMs significantly improve the levels of compliance with those regulations. Over the past several years the procedures utilized by the Commission staff when auditing member FCMs have been considerably streamlined so that these audits take much less time to conduct. That is the primary reason why the Commission staff has been able to conduct more audits of non-members and CPOs without conducting significantly fewer audits of members. The Commission considers this efficiency not a deficiency. Simply comparing the total number of member audits (150) to the total number of non-member audits (150) is not an accurate measure of the level of audit coverage. First, because of the streamlined procedures utilized in member audits the amount of staff hours spent on non-member audits was significantly greater than that expended on member audits. Second, it's important to recognize that there are more than three times as many members as non-members. In any event, however, the Commission staff will not be able to audit member FCMs as frequently in the future because of the additional resources being devoted to auditing CPOs. In fact, approximately 70% of the FCM audits conducted during the first four months of fiscal year 1982 have been of non-members.

THE COMMISSION SHOULD DEVOTE ADDITIONAL AUDIT RESOURCES TO MONITORING NONMEMBER FCMS AND CPOS

The Commission recognizes the importance of auditing and monitoring "non-member" FCMs on a frequent basis. In fact, major steps have already been taken to accomplish this. For example, beginning in December 1980, the Commission required non-member FCMs which hold customer funds to contact the Commission's audit staff on every business day to report their segregation calculations, and written segregation reports must be filed weekly. In addition, to the extent possible, the audit staff visits each non-member FCM with over $1 million in customer funds at least once each month to perform a limited scope audit. While the draft GAO report acknowledges that the Commission has increased the number of audits of non-member FCMs it fails to mention these substantive new audit and surveillance techniques.

The Commission does not believe that its audit coverage of non-members has been inadequate. The draft report indicates that 83 non-member FCMs were registered at the end of fiscal year 1981. The draft report also mentions that no audits were conducted of 33 non-members (none of which held customer funds on September 30, 1981). Therefore, based on the fact that 150 audits of non-members were conducted during fiscal year 1981, it would appear that remaining non-members were audited an average of three times during the year.

The Commission disagrees with the contention that it is necessary to audit each non-member FCM at least once every two years even if the FCM does not hold customers' funds. The protection of customers' funds is by far the most important reason for conducting financial audits of FCMs. Therefore, firms with no customer funds will always constitute the lowest audit priority. Furthermore, the draft report fails to adequately explain that while 33 non-members were not audited by the CFTC, those FCMs were audited each year by an independent public accountant, and the FCMs filed quarterly financial reports which were thoroughly reviewed by the Commission's audit staff.

The Commission also recognizes the necessity to conduct more audits of CPOs. This has already begun. For example through the first four months of fiscal year 1982, the Division of Trading and Markets has completed 37 financial audits of CPOs. At this rate 111 financial audits of CPOs would be completed during Fiscal Year 1982, or a more than 50% increase over Fiscal Year 1981. In addition, staff hours are being devoted to CPO financial audits at about twice the level of fiscal year 1981.

THE COMMISSION SHOULD PROVIDE ADDITIONAL SPECIFIC GUIDANCE FOR THE CONDUCT OF EXCHANGE AUDIT AND FINANCIAL SURVEILLANCE PROGRAMS

The Division of Trading and Markets' Interpretation No. 4 was intentionally structured to provide guidance to exchanges rather than to dictate that each exchange adopt identical procedures and program elements. While it is important that all exchange programs meet certain basic requirements, each exchange should be encouraged to develop programs to fit its special circumstances. The Commission believes that Interpretation No. 4 provides adequate guidance to the exchanges, and accordingly the Interpretation need not be amended.

THE COMMISSION SHOULD WORK WITH THE AICPA TO ENSURE THE TIMELY PUBLICATION OF AUDIT GUIDELINES FOR USE BY INDEPENDENT PUBLIC ACCOUNTANTS IN PERFORMING AUDITS OF FCMS

The Commission continues to believe that detailed guidelines for conducting audits of FCMs should be developed by the accounting industry, i.e. the AICPA's Auditing Standards Sub-Committee on Commodity Futures. The Commission staff will work with the Sub-Committee in order to develop and issue guidelines as soon as practicable. The staff will, of course, ensure that such guidelines meet the CFTC's needs and satisfy its requirements.

THE COMMISSION SHOULD DEVELOP A PLAN FOR THE TRANSFER OF SPECIFIC AUDITS FUNCTIONS TO THE NFA

The Commission does not believe that it would be an appropriate use of its limited resources at this time to develop a formal plan for delegating audit and financial surveillance responsibilities to the NFA. The staff of the Division of Trading and Markets has had a number of discussions with the organizers of NFA concerning audit and financial surveillance activities and this dialogue will continue. However, until such time as NFA engages an audit staff, efforts to develop a formal plan would be of little benefit and certainly not worth the resource commitment.

THE COMMISSION SHOULD PERFORM MORE FREQUENT REVIEWS OF THE EXCHANGES' AUDIT AND FINANCIAL SURVEILLANCE PROGRAMS AND PERFORM MORE ACTIVE FOLLOW-UP SO THAT EXCHANGES MODIFY THEIR AUDIT AND FINANCIAL SURVEILLANCE PROGRAMS TO COMPLY WITH CFTC'S RECOMMENDATIONS

The Commission agrees that reviews of exchange programs should be performed on a frequent enough basis to ensure continued compliance with the self-regulatory requirements of the Act and CFTC regulations. However, we do not agree with the conclusion that such reviews to date have been insufficient. It is important to note that staff members of the Division of Trading and Markets have very frequent contact with the audit staffs of the exchanges in which problems or concerns about an exchange's program are discussed and rectified. While periodic formal program reviews are necessary and will be continued, the day-to-day oversight function is equally if not more important.

The Commission does not agree with the conclusion that it has not been forceful enough in requiring exchanges to adopt recommendations made as a result of audit and financial surveillance program reviews. The vast majority of recommendations made by the Division of Trading and Markets have been adopted by the exchanges. The staff has not accomplished this by being passive. In addition, with respect to the specific example cited in the draft report it should be noted that the New York Cotton Exchange's overall program was quite good and that we know of no instance in which the New York Cotton Exchange failed to notify the Commission of financial or segregation violations it has discovered.

CHAPTER 7

Chapter 7 of the GAO Report examines the CFTC's rule enforcement review program and concludes that "while some significant improvements have been made, there remain weaknesses of a serious nature." The GAO asserts that these weaknesses include the largely descriptive nature of rule enforcement reviews, problems relating to the planning, scoping and conduct of reviews, inefficiencies in the use of staff resources and expertise, lack of prompt follow-up on report recommendations, and insufficient Commission direction, control, and support of the rule enforcement review program.

The Division believes that the GAO Report does not give a fully accurate picture of the Division's rule enforcement review program, nor does it take into account all of the improvements which the Division has implemented in the program or the significant intervening events which have caused some delays in completing recent major rule enforcement reviews. Moreover, in reaching its conclusions, GAO places exaggerated and unfounded emphasis on its flawed review of a Division inspection of the New York Mercantile Exchange ("NYME") which can in no way be characterized as representative of the overall program. The following discussion is intended to provide GAO with the Division's comments concerning the descriptive nature of Division reports, the misplaced and inaccurate analysis of the Division's review of the NYME, the proper focus of Division reviews, factors which have caused delays in completing some recent reviews and GAO's conclusion that the Division has not found a way to keep current with exchange rule enforcement programs. Following the discussion of these major points, other specific inaccuracies in the GAO Report are noted.

1. Rule enforcement review reports will, of necessity, always involve a certain degree of descriptive material in presenting the Division's evaluation of each exchange's program. This descriptive material serves two purposes:

(a) To document the nature and uses of the exchange rule enforcement programs or systems which the Division has evaluated; and

(b) To provide the Commission and other readers of the report a sufficiently adequate basis for understanding any criticisms or recommendations which the Division may make with respect to the exchange programs evaluated.

Apart from recognizing the need for a certain amount of descriptive material in any rule enforcement review, the GAO does not adequately acknowledge that the most recent reviews have gone considerably further than previous reviews in providing specific documentation designed to assess the actual operational effectiveness of exchange programs. In this regard, the planning, conduct and actual reports associated with recent reviews have all been directed toward evaluating actual exchange investigations and systems and presenting that documentation in the reports presented to the Commission.

2. The GAO Report cites as a primary example of its perceived inadequacies in the conduct of the Division's program an inspection of the New York Mercantile Exchange. The GAO's characterization of that Report completely misrepresents the nature and limited purpose of the Division's review as well as mischaracterizes the results of the Division's review in comparing it with a concurrent Division of Enforcement investigation of the NYME. As serious as these misrepresentations themselves are, their impact has been further exaggerated by GAO testimony before Congressman Rosenthal, in which senior GAO officials ignore the GAO Report's general findings and repeat the Report's mischaracterization of the Division's review of the NYME.

The GAO's overall conclusion with respect to the Division's rule enforcement review program is that "while some significant improvements have been made, there remain weaknesses of a serious nature." In testimony before Congressman Rosenthal, however, Henry Eschwege, a Divisional Director of the GAO, completely disregarded his Office's general conclusion and stated that "rule reviews have improved marginally" but that "substantial improvements are still required." In addition to this erroneous statement, Mr. Eschwege also repeated the misrepresentations of the staff report by stating that "a CFTC review of the NYME conducted in 1980 overlooked serious problems brought to light in a separate 1980 CFTC Enforcement investigation".

The GAO Report and Mr. Eschwege's testimony assert that the conclusions of Trading and Markets' review "were almost totally contradicted" by the Enforcement investigation and leave the clear impression that one arm of the Commission staff was completely unaware of a contemporaneous pending investigation being conducted by another arm of the Commission's staff. In fact, nothing could be further from the truth—a truth documented in staff memoranda to the Commission made available to GAO, but which GAO has chosen to ignore. In particular, the GAO report makes no mention of a May 12, 1980 memorandum from the Division of Trading and Markets to the Commission in which the nature and results of its inspection are discussed. Instead, GAO relies entirely on the initial report of the Division of Trading and Markets' regional staff; a report which itself was never transmitted to the Commission and, both within the Division of Trading and Markets and as explained to GAO staff, was viewed as having a very narrow purpose and limited depth.

The following specific points summarize information previously made available to the GAO concerning its treatment of the NYME review:

(a) The GAO Report ignores the extremely limited nature and scope of the Division of Trading and Markets' review and the reasons for conducting the review. The Division of Trading and Markets initiated this review specifically in light of its knowledge of the Division of Enforcement's investigation because the Commission at that time was to consider major rule changes designed to eliminate serious and recurring problems in the NYME potato contract. Thus, the Division of Trading and Markets' report focuses substantially on the NYME's surveillance capabilities with respect to potato futures trading. The limited scope of the Division of Trading and Markets' review is clear from the fact that the entire staff work on this review consumed only 240 hours, whereas typical rule enforcement reviews conducted by the Division have consumed as much as 2,000 staff hours. This fact is noted in the Division of Trading and Markets' May 12, 1980 memorandum in which the Division states that "this effort was not structured to be a full scale rule enforcement review or to obviate the need for such review in the course of the Division's ongoing rule enforcement program."

(b) The GAO Report at page 106 states that the Division of Enforcement's investigation into trade practice abuses at the NYME "originated in referrals from CFTC market surveillance personnel." The initial referral originating from market surveillance in this matter was transmitted jointly to the Divisions of Enforcement and Trading and Markets. By memorandum dated February 2, 1978 both Divisions agreed that the Division of Trading and Markets would conduct the initial inquiry into the market surveillance referral. This Division proceeded with its inquiry and, by memorandum dated June 9, 1978 presented the Division of Enforcement with its findings. Those findings were the basis of the Division of Enforcement's preparation of a formal order of investigation and the ultimate complaint filed by the Commission in this matter. The Division revives this history at this time only to demonstrate that it has since early 1978 been actively involved in evaluating the rule enforcement capability of the NYME. The Division's continual awareness of the investigation and findings of the Division of Enforcement are an inescapable fact.

(c) GAO expresses its perplexion that, having previously conducted basic reviews of the NYME, the stated purpose of this Division of Trading and Markets' review was to determine whether the NYME had any rule enforcement program in place. The May 12, 1980 memorandum from the Division of Trading and Markets answers GAO's questions by stating that the purpose of the Division of Trading and Markets' inspection was to provide the Division with current information on the self regulatory performance of the Exchange. The Division's May 12, 1980 memorandum states clearly that its review was initiated specifically in light of the Division of Enforcement's investigation, which by then had confirmed serious violations of the Act by NYME members in two contracts traded on that Exchange and in response to the Division of Enforcement's questions as to whether NYME ought to be designated as a contract market in any contract, including potatoes. The Division of Trading and Markets was clearly aware of the Division of Enforcement's concerns with respect to the NYME program and it was precisely those concerns which led it to review whether NYME had a basic self regulatory program in place.

(d) The GAO Report leaves the impression that the focus of both the Division of Trading and Markets and the Division of Enforcement inquiries was the same time period. In fact, the Division of Enforcement's inquiry was focused on trading abuses in two contracts trading on the NYME during 1977 and 1978. The Division of Trading and Market's review focused on a time period in late 1979 and early 1980 over one year after the abuses which the Division of Enforcement was investigating had occurred. More importantly, the Division of Trading and Markets' staff report on the NYME compliance program clearly shows that the Exchange had made notable improvements in its compliance program during that one year interim period. Specifically, the staff report at page 8 notes that in January 1980, the Compliance Department had hired three new investigators and one auditor. In addition, the Exchange was at that time reorganizing its compliance staff into two independent sections, one for trade surveillance and the other for financial surveillance. While neither the initial staff report or the Division of Trading and Markets' subsequent memorandum to the Commission indicated in any way complete satisfaction with improvements in the NYME program, it is clear that significant changes in that program had been effected between the time that the Division of Enforcement was investigating and the time at which the Division of Trading and Markets conducted its review.

(e) The GAO Report's conclusion of contradictory Division findings is erroneous. In fact, in its May 12, 1980 memorandum to the Commission on this subject, the Division of Trading and Markets recognized the limited nature of its inquiry and the potential that the Division of Enforcement would find serious violations during the time period it reviewed. However, it also recognized that there was a significant public interest in seeing improvements to the NYME potato contract effectuated. The Division thus noted that "whatever conclusions the Division of Enforcement may reach with respect to the adequacy of the NYME compliance program, the Commission's review of these rule proposals under section 5a(12) of the Act is unlikely to provide an appropriate forum for consideration of the recommendations which the Division of Enforcement may make with respect to the future of the NYME. Even if the Exchange's compliance program were found to be inadequate, the Division does not believe it would be appropriate for the Commission to defer approval of these amendments, since they effect changes in the contract which represent a distinct improvement in the contract and appear to serve a broader public interest in the proper functioning of the contract. Further, approval of these rules does not jeopardize the Commission's authority in any other context to take enforcement action against the NYME or seek vacation of its designation in this or any other contract." (emphasis added)

3. Following the GAO's 1978 Report, the focus of the Division of Trading and Markets' Rule Enforcement Reviews shifted from broad-based reviews of each exchange's entire rule enforcement program to more narrow inquiries directed at specific aspects of each exchange's self-regulatory programs. This change in focus recognized the difficulty of gaining more than a superficial understanding of an exchange's overall program when attempting to review the entire breadth of such programs. The new focus has allowed the Division to target its rule enforcement resources at specific aspects of exchange programs which the Division has reason to

believe may be deficient or which otherwise merit scrutiny. Recent examples include reviews of the Coffee, Sugar and Cocoa Exchange's trade practice program and a review of the Kansas City Board of Trade's procedures for monitoring trading at the close.

Further, in criticizing the Division's selection in its pending CBT rule enforcement review of only two of the eight regulation 1.51 criteria required of exchange rule enforcement programs, the GAO Report makes no mention that the two elements selected for review are the two most significant elements, that other elements are largely derivative from or dependent upon successful exchange implementation of those two elements, or that the previous CBT review found the most serious deficiencies in its programs required by those two elements.

Finally, while the Division respects the effort and independent viewpoint which the GAO staff has brought to its audit of the Division's performance in this area, the Division strongly believes that the conduct of limited scope reviews is essential to its ability to deliver timely, yet thoroughly documented analyses of exchange's self-regulatory performance. Unfortunate as the delays in completing the current CBT and CME reviews have been, the Division believes it would be inviting similar delays in other reviews if it abandoned its efforts to specifically target its reviews to those exchange programs which are most essential or which have caused the Commission to have specific concerns as to their adequacy.

4. As noted above, GAO correctly observes that a significant period of time has elapsed between rule enforcement reviews of both the CBT and CME and notes that, while pending reviews of those exchanges are near completion, their completion has extended over a considerable length of time. First, it should be noted that the Division has committed itself to completing the CBT review by the end of March and the CME report in mid-April.

Second, notwithstanding the change in focus of the Division's reviews, a review of even limited aspects of a major exchange's program is a significant undertaking. In order to fully understand how those specific aspects of an exchange's program operate and whether they are effective, Division staff conduct extensive interviews of exchange compliance and supervisory personnel, as well as selected members; review and reconstruct exchange investigations of trading activity or financial audits; and conduct independent trade practice investigations to determine whether the scope and thoroughness of exchange programs are adequate.

These rule enforcement review functions are conducted by a limited staff, whose additional routine duties include daily floor surveillance, review of exchange disciplinary and emergency actions, the conduct of routine trade practice investigations, and review of exchange rules relating to trading practices and disciplinary procedures.

The GAO has noted that three recent rule enforcement reviews (one completed—Comex, two pending—CBT and CME) have consumed more time than initially planned by staff. In addition to the traditional rule enforcement scope of each of these reviews and the Division's attempt to thoroughly document its analyses, each of these reviews took on the additional burden of analyzing significant exchange emergency actions taken in the context of major price movements in metals contracts traded on those exchanges. In two of the three reviews, this added task has involved an in-depth review of allegations that Board members involved in decisions to take emergency actions had conflicts of interest. This review required major expenditures of time and resources to identify Board members' relevant positions and to analyze how those positions might have affected any actions taken.

Finally, the Division notes that a number of intervening events have caused substantial diversions of available resources from the conduct of ongoing rule enforcement reviews. During the past two years alone, the necessary involvement of the Division's Rule Enforcement Review Unit in monitoring the silver situation; subsequently investigating various conflict of interest allegations related to the silver situation; reviewing the rule enforcement, disciplinary, and trade practice aspects of initial designation applications by both the New York Futures Exchange and the New Orleans Commodities Exchange; and reviewing the rule enforcement and disciplinary aspects of the NFA registration application has diverted approximately 2½ staff years from the conduct of formal rule enforcement reviews of ongoing exchange operations.

In none of these instances can the Division conclude that the time diverted from perhaps more traditional rule enforcement activities was unnecessary or ill-spent. Indeed, the Division believes that its involvement in monitoring developments in the silver market and its aftermath were absolutely essential. Further, the Division believes that the resources which it expends in assuring that an exchange commences operations only if it has a fully satisfactory rule enforcement program can only result in better protection of the public and consequent savings in staff resources in subsequent years. Similarly, the Division has attached and will continue to attach priority importance to assuring that proposed NFA programs are fully consistent with the Act and designed to make that organization an effective supplement to existing self-regulatory efforts.

5. The GAO Report concludes that staff and the Commission "have not yet found a way to keep current of exchange rule enforcement." Implicit in this statement is that rule enforcement reviews are the only means by which it is possible to have a up-to-date understanding of an exchange's program. In fact, however, as has been stated to GAO on more than one occasion, a rule enforcement review is only one of a number of methods by which to keep track of such programs. Other means used include trade practice investigations, which have increased in recent years from 45 in Fiscal Year 80 to 75 in Fiscal Year 81 and which have resulted in numerous referrals to either the exchanges or the Division of Enforcement; routine daily floor surveillance; ongoing reviews of exchange disciplinary notices and emergency actions; and the review of exchange rules relating to trading practices and disciplinary procedures.

Indeed, to take but one example, the Division recently expressed reservations concerning the adequacy of the New York Mercantile Exchange's rule enforcement review program when evaluating its application to trade a Gulf Coast No. 2 Heating Oil contract. The Division stated its concerns in a memorandum dated July 21, 1981, a copy of which was provided to GAO. The Division's concerns with respect to this proposed designation arose not as a result of a rule enforcement review, but rather as a result of the Exchange's handling of four recent referrals to the Exchange made by the Division. Accordingly, the Division believes the GAO Report should correct the misimpression that current evaluations of exchange programs can be obtained solely through rule enforcement reviews.

* * * * * * *

In addition to these general observations on Chapter 7, the Division offers the following specific comments:

1. The GAO Report at page 94 states that "significant improvements have been made", yet nowhere in the introduction to the chapter is this conclusion mentioned. At the conclusion of the chapter, at page 122, the Report states only that reviews have improved "somewhat".

2. The Report at page 95 lists improvements in the rule enforcement review program proposed in 1979 by the Director of T&M, then goes on to state that only some of the improvements have been adopted. All of the improvements proposed, however, have been incorporated into the program, including reviewing the exchanges' original source material and reviewing areas not investigated by the exchanges, areas of improvement not recognized in the Report. In addition, as discussed above, the Report fails to note that the more recent reviews, although by necessity somewhat descriptive, assess the actual operational effectiveness of exchange programs.

3. Although page 95 of the Report states that reviews are "supplemented to some extent" by follow-up reports to the Commission, page 96 states that staff has not promptly followed-up on reviews. This criticism ignores, however, documentation provided to GAO which shows that staff diligently has followed-up on recent reviews. Specifically, GAO was provided with correspondence between staff and Mid-America Commodity Exchange concerning certain recommendations made in the report to the Commission presented in July 1980, which correspondence reflected continuing concerns regarding the Exchange's disciplinary program and procedures regarding the use of the changer. In addition, upon the request of the Contract Markets Section, the Front Office Audit Unit, in the course of reviewing the office procedures of certain FCMs, reviewed whether those FCMs which also were members of MACE were complying with the new disclosure requirements concerning the changer fee. Through this follow-up, the Division has assured that all of the points noted in its review report on MACE have been addressed by the Exchange.

More recently, staff reviewed the implementation of the Coffee, Sugar and Cocoa Exchange's new computer surveillance system. This follow-up review was conducted because, at the time the Division presented its final report on this Exchange to the Commission, its computer program had not yet been implemented. An informational memorandum, dated October 14, 1981, describing the operations and capabilities of this new computer system, as well as some of its limitations, was sent to the Commission and a copy provided to GAO. See also comment No. 11 below.

4. As discussed in the Division's general observations, GAO notes at pages 97 and 112 of its Report that the current review of the CBT examines only two of eight subprograms in regulation 1.51. GAO neglects to mention, however, that the two

subprograms examined are the two most important for an effective rule enforcement program and the two in which the Division found the CBT to be most deficient in 1978.

5. On page 98 of the Report, GAO presents some statistics representing staff years attributed to rule enforcement reviews. These numbers, however, fail to reflect time spent on examining the rule enforcement programs of NYFE, NOCE and the National Futures Association.

6. On page 100, GAO provides the Division's plan for rule enforcement reviews for fiscal year 1980. Although the chart makes clear that the anticipated schedule for completion was not met, it does not adequately reflect reasons for the delay. For example, at the beginning of fiscal year 80 (October 1, 1979), the anticipated date for the review of NYFE was September 30, 1980, yet NYFE did not begin trading until August 7, 1980.

Moreover, as noted in the Division's general observations, a number of intervening events necessitated adjustments to the Division's plans.

7. At page 101 GAO relies upon a statement made by the "Associate Director" in stating that, although eight reviews are planned for fiscal year 82, no exchanges have been selected. In fact, it was an Assistant Director, and he stated that although all eight reviews have not yet been planned, a number had been. For example—as GAO itself notes on the preceding page—a review of NYFE was begun in November, 1981 (fiscal year 82). In addition, review of the KCBT and New York Cotton Exchange are in the preparatory stages.

8. At page 102, n. 1, GAO states that the rule enforcement procedures manual was finalized and adopted in late 1981. In fact, it was finalized and adopted in early 1981. In addition, it should be noted that the manual merely formalizes procedures which previously had been established.

9. At pages 105-108 GAO compares the review of the New York Mercantile Exchange with the results of an enforcement investigation. Our comments on these pages are provided above.

10. On pages 117-118, GAO discusses the question of one minute timing of trades. Contrary to the Report, opposition to one-minute timing was expressed by virtually all exchanges and, as recommended by the GAO in its 1978 report, the Commission did consider the feasibility of such a system. As stated by the Commission in the December 2, 1980 Federal Register announcement of the adoption of amendments deleting the requirement of one minute timing and substituting a 30 minute bracketing requirement:

"The Commission's determination not to continue with one-minute timing as a requirement of its regulations is influenced considerably by the lack of evidence that technology is currently available to permit all of the exchanges to adopt one-minute timing systems and the concern that, absent such technology, the adoption of one-minute timing as an absolute requirement would invite major disruptions to the effective performance of the nation's commodity futures markets. Until such time as the Commission is persuaded that technological or other program or systems developments are capable of implementing more precise timing, timestamping or transaction sequencing systems, without posing a significant threat of market disruption, the Commission does not believe that a continued commitment to one-minute timing is in the public interest."

One minute timing is utilized currently by three of the smaller exchanges, the New York Mercantile Exchange, the Minneapolis Grain Exchange and in a modified form by the Kansas City Board of Trade. Thus, although one minute timing of trades would enhance the ability of the exchanges and others to reconstruct trading, the Commission's determination not to require one minute timing was based on its belief that current technology is inadequate to implement such systems without risk of disrupting current market activity. In addition, it must be remembered that the regulatory objective of obtaining accurate sequencing of trades would not be accomplished completely even with one-minute timing (particularly during active trading periods) and that one-minute timing would not be sufficient to detect all types of dual trading abuses.

[The following questions were submitted by Senator Boren:]

COMMODITY FUTURES TRADING COMMISSION,
Washington, D.C., March 29, 1982.

Hon. Richard G. Lugar,
Chairman, Subcommittee on Agricultural Research and General Legislation, Committee on Agriculture, Nutrition, and Forestry, Russell Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: This letter is written for the purpose of responding to a number of questions Senator David Boren submitted for the record during the March 1 hearings on the Commission's reauthorization before your Subcommittee. I am pleased to forward the following responses to Senator Boren's questions for your review:

1. The amendments to the Commodity Exchange Act proposed by the futures industry include provisions to remove a perceived anti-speculative bias from the Act; to reallocate to contract markets the initial responsibility for establishing speculative limits; and to provide expressly for judicial review of CFTC determinations of emergency.

Does the Commission have a position on these proposals? What are your views on these issues?

Response: (a) The Commission believes that moderate speculative activity in futures markets contributes to market liquidity and usefulness of the markets for risk shifting by commercial interests and reaffirmed this view in the Federal Register notice accompanying its final rules which require exchanges to establish limits for all futures markets.

Section 4a of the Act, which authorizes the Commission to establish speculative limits, merely addresses "excessive speculation" which may constitute a burden on interstate commerce. Accordingly, limits maintained by the Commission under this section of the Act, or established by the exchanges under the Commission's new Regulation 1.61 are not intended to control speculation per se. Instead they limit the total size of speculative positions which can be maintained by a particular individual or group of individuals acting in concert and which may be detrimental to the proper functioning of the market.

On the other hand, the Commission has no objection to the deletion of nonsubstantive words or phrases in Sections 3 or 4a of the Act that might be construed as pejorative as to speculation, provided that no impairment of the Commission's powers results.

(b) Under the Commission's new regulation 1.61, contract markets have already been given the initial responsibility for establishing speculative limits in the numerous cases where limits have not previously been imposed by the federal government. Accordingly, the Commission does not believe an amendment for this purpose is necessary. Nevertheless, to underscore the importance that the Commission attaches to regulation 1.61, the Commission has proposed a new Section 4a(5) to the Act, which specifically confirms the authority of the contract market to set speculative limits and would make violations of those limits an offense under the Act as well as under exchange rules. In this way, both the exchanges and the Commission would be expressly empowered to compel adherence to speculative limits (see Section 4 of S. 2109).

The Commission understands that some of the contract markets which are subject to new Rule 1.61 disagree with its determination that speculative limits are necessary in every futures contract since the nature of each market may vary somewhat. However, the Commission considered these views carefully during rulemaking proceedings which led to the new rule, and stated its reasons for the requirement in the release accompanying the final rule. Among other things, the prevention of large and/or abrupt price movements which are attributable to extraordinarily large speculative positions is a congressionally endorsed regulatory objective of the Commission. Further, it is the Commission's view that this objective is enhanced by speculative position limits for each market since it appears that the capacity of each market to absorb the establishment and liquidation of large speculative positions in an orderly manner is related to the relative size of such positions, i.e., the capacity of the market is not unlimited. Recent events in the silver market would support a finding that the capacity of a liquid futures market to absorb large speculative positions is not unlimited, notwithstanding mitigating characteristics of the underlying cash market. None of the commentators opposing the adoption of limits for all markets demonstrated to the Commission's satisfaction that such a finding is unwarranted.

Finally, the new rule provides for exercise of contract market expertise and flexibility in the determination of proposed levels of speculative limits. In that connection, the Commission has noted that there may be an appropriate range of levels at which contract markets may prescribe limits which would not significantly influence market liquidity, but which would prevent extraordinarily large positions from disrupting the markets. It has also noted factors such as the breadth and liquidity of the underlying cash market which exchanges may wish to consider in proposing the particular level of limits for various commodities.

(c) The futures industry has proposed an amendment to Section 8a(9) that would expressly provide for judicial review of both Commission emergency determinations as well as the remedy selected by the Commission to deal with the emergency. It is important to note that the industry's proposal could allow injunctions to be issued before the Commission's emergency orders are able to take effect in the market. The Commission opposes such changes in the law. In 1974 Congress was informed that situations could arise in the volatile futures markets which required swift remedial measures. Congress also heard testimony that in these situations, an exchange might disagree that an emergency existed or might otherwise be unwilling to take appropriate action. Congress also appreciated that traditional government enforcement remedies might be ineffective to deal with market emergencies. Congress thus vested new and extraordinary authority in the Commission to determine whether a market emergency exists and the steps necessary to address the problem. In making these determinations, the economic and other factors to be considered and the relative weight to be accorded those factors were left to the "expert and impartial judgment" of the Commission. S. Rep. 1194, 93d Cong. 2d Sess. 38 (1974) (Report of the Conference Committee).

In exercising its emergency power, the Commission must consider the broad public interests to be served by orderly futures trading, not only the interests that a particular exchange or single group of traders may have. The Commission must also evaluate complex economic factors in order to determine, for example, whether there exists a "threatened" manipulation or circumstances which constitute "a major market disturbance which prevents the market from accurately reflecting the forces of supply and demand" for a commodity. Thus, whether an emergency exists is not a question of fact, capable of verification by evidence which opposing parties may present to a court. Rather, it is a judgment made upon weighing various factors, uniquely suited to the Commission's expertise.

Moreover, all of these factors must be weighed in an often volatile trading situation and possibly in the midst of a evolving market crisis. In these circumstances, timing is paramount. If the Commission were simultaneously required to prepare to go to court (i.e., prepare witnesses, pleadings and documentation of each development in the trading of a particular contract) it would be impossible for the Commission to act in a timely fashion to protect the markets. The emergency order might have to be issued prematurely, in order to prepare for a court challenge, or it might have to be issued after court preparation, and thus too late to be fully effective.

The Commission, of course, recognizes the extraordinary nature of its emergency power. Consistent with the congressional purposes in enacting Section 8a(9), the Commission has exercised its emergency authority deliberately and with restraint and only as a last resort. Since its inception in 1975, the Commission has invoked its Section 8a(9) power on only four occasions—during the 1980 Russian grain embargo and in three specific market situations. The Commission's emergency orders have impacted trading on only 25 days in nearly seven years and have halted trading for only 3 days in particular contracts. Each of the Commission's emergency actions has been the subject of subsequent and thorough congressional oversight.

The Commission is not suggesting that its emergency actions should never be reviewed. Consistent with its position in an earlier attempted judicial challenges, the Commission did not argue, nor did the Court of Appeals for the Seventh Circuit hold in the March 1979 Wheat case, that a Commission emergency action is immune from any form of judicial review. Both the Commission and the Court recognized that action committed to agency discretion—like that taken by the Commission under Section 8a(9)—is judicially reviewable where the action is challenged on constitutional grounds or upon a claim that the agency has acted in bad faith or in a manner plainly repugnant to its statutory authority. *Board of Trade of the City of Chicago* v. *CFTC*, 605 F.2d 1016 (7th Cir. 1979), cert. denied, 446 U.S. 928 (1980). This treatment of Commission emergency orders is similar to that which the courts give to emergency actions taken by the exchanges themselves. In such cases, the courts do not second guess the judgment of the exchanges on the merits of the emergency decision, but instead limit judicial scrutiny to whether the exchange has acted fraudulently or in bad faith. See, e.g., *Lagorio* v. *Board of Trade of the City of Chicago*, 529 F.2d 1290 (7th Cir.) cert. denied, 425 U.S. 950 (1976); *Daniel* v. *Board of Trade of the City of Chicago*, 164 F.2d 815 (7th Cir. 1947).

Similarly, the courts should not be called upon to substitute their judgment for that which Congress has decreed the Commission is to exercise. The Commission continues to believe that the most effective review of the correctness of the Commission's emergency orders lies with those who conferred that power—the Congress. And Congress has actively overseen the Commission's exercise of its emergency authority. That oversight has demonstrated that the Commission has acted cautiously and judiciously in invoking its power. Therefore, there is no justification, and much peril, in amending the provisions of Section 8a(9) to alter existing law.

2. The General Accounting Office recommends that the Commodity Exchange Act be amended to provide aggrieved commodity purchasers an explicit cause of action against commodity professionals who violate the Act.

Will you give us the background on this issue, and tell us your views on this recommendation?

In its draft report GAO has recommended that, in order to resolve the issue of the availability of federal court litigation, Congress should clarify its intent regarding whether customers have a private right to action to adjudicate commodity-related claims in federal court, even though these claims might also be submitted to the CFTC's reparations program for resolution.

Prior to 1974, lower federal courts had held that customers could seek damages for violations of various sections of the Commodity Exchange Act, although the Act did not expressly provide for such a remedy. In 1974, Congress extensively amended the Act and created an express damage remedy in Commission reparations proceedings for aggrieved customers of commodity professionals. The Commission has always understood that the 1974 amendments, including the reparations provisions, were designed to supplement—not supplant—the remedies available to customers.

Whether a private right of action is implied depends mainly on the intent of Congress. Thus, in two cases presently pending before the Supreme Court, the Commission has taken the position that Congress intends that there be available an implied private right of action for injured persons. *New York Mercantile Exchange, et al.* v. *Leist, et al.*, (Nos. 80-757, 80-895 and 80-936) and *Merrill Lynch, Pierce, Fenner and Smith, Inc.* v. *Curran* (No. 80-203). Both cases have been argued and are awaiting the Court's decision.

Because of the possibility that the Supreme Court may decide these cases inconsistent with the Commission's position (and our understanding of current congressional intent), the Commission would have no objection if Congress were to address this subject by expressly creating a private right of action for damages which would allow individuals to sue in federal court for violations of the Commodity Exchange Act committed by commodity professionals and, under certain circumstances, by the exchanges.

Accordingly, the Commission would support legislation that would expressly provide for private damage actions in Federal Court against:

(1) any individual, firm or other person, whether or not registered or required to be registered with the Commission, who violates any provision of the Act, or who aids or abets the violation, or who conspires in a violation by another person and

(2) any contract market or other board of trade licensed by the Commission for a violation of a provision of the Act; except that a contract market or licensed board of trade should not to be subject to private rights of action alleging only that it failed to perform a self-regulatory duty set forth in the Act unless it is alleged that the failure was committed to assist the violator or was motivated by self-interest among its Board of Governors or responsible Committee.

3. The General Accounting Office recommends that legislation be enacted to increase the dollar limitation on arbitration cases; and to authorize CFTC to disclose surveillance information to contract markets.

Does the Commission have a position on these proposals? What are your views on these issues?

In its draft recommendations GAO has proposed raising the dollar limitation for contract market and futures association arbitration from $15,000 to $25,000 and permitting the Commission to raise this dollar limitation farther, but not to exceed $50,000. The Commission recognizes the benefits of arbitration and agrees that the dollar limitation on contract market and futures association arbitration under present Sections 5a(11) and 17(b)(10) of the Act, respectively, are too low. However, the Commission believes that there should be no dollar limitation on the amount of claims which may be arbitrated in these forums. Thus, the Commission has submitted proposed legislation to Congress recommending that the dollar limitation in these sections be deleted entirely. See Sections 14 and 24 of S. 2109. The Commission believes that by removing any dollar limitation, arbitration would be encouraged, the level of claims could keep pace with inflation, and the necessity of either the

Commission or the Congress adjusting the dollar level of claims from time to time would be eliminated.

The Commission agrees with the GAO recommendation that Section 8a(6) of the Act should be amended so as to authorize the Commission to disclose routinely large trader and other surveillance information to contract markets. In its proposed amendments to the Commodity Exchange Act submitted to Congress, the Commission has specifically recommended an amendment to Section 8a(6) which would, among other things, expand the authority of the Commission to make disclosures of information to contract markets, notwithstanding the confidentiality provisions of Section 8 of the Act. See Section 18(f) of S. 2109. Under the Commission's proposal it would be permitted to disclose market information, including the identity of large traders to the exchanges, whenever, in the judgment of the Commission, the disclosure of such information would be necessary or appropriate to effectuate the purposes of the Act. The purposes of the Act, of course, recognize that commodity exchanges, as self-regulatory organizations, should be in the forefront of market surveillance. The routine sharing of information by the Commission with the commodity exchanges will effectuate that purpose. The Commission's proposal also contains appropriate safeguards by requiring that any information disclosed by the Commission be kept confidential by the contract market except in a self-regulatory action or proceeding of the contract market.

4. The General Accounting Office criticizes the CFTC rule-enforcement review program for being understaffed, descriptive in nature, and without a strong follow-up effort. What is your response to GAO's analysis?

The GAO's criticisms of the Commission's rule-enforcement review program are contained in Chapter 7 of its draft report. The Commission recently provided the GAO with extensive comments concerning this chapter. We are attaching for your information a copy of that response.

5. What lessons did the CFTC learn from the silver run-up episode in 1979 and 1980; and do any of the Commission's proposals for legislation address this matter directly or indirectly?

The CFTC handled the situation in silver as well as the tools available at that time permitted. At the same time, some lessons were learned which will make stronger tools available in the future. From a regulatory perspective, the silver episode underlined two areas in which commodity futures markets are vulnerable to concentrated market positions. First, the accumulation of large long positions in commodity futures markets and their real or anticipated subsequent conversion to physical commodities (by speculators or investors who own or control substantial financial resources) can exert a considerable unsettling influence upon commodity futures and related cash markets. In this regard, the accumulation of large long futures positions by members of the Hunt family and certain foreign traders, and the desire and apparent financial ability of some traders to take delivery of physical silver on these positions, may have contributed significantly to the observed silver price increases during 1979–80. Second, the maintenance of large long futures positions during periods of rapidly declining market prices can create potential for financial stresses both within and outside the futures industry due to the inability of even financially well endowed traders to satisfy futures variation margin calls in a timely fashion. This aspect of the silver episode became apparent in late March 1980 when certain members of the Hunt family were unable to comply with margin calls induced by rapidly declining silver prices. Subsequently, considerable concern was expressed over the financial stability of certain futures commission merchants (FCMs) servicing the Hunt accounts. This concern also extended to a number of banks which had made substantial loans to the affected FCMs as well as directly to members of the Hunt family. While all financial obligations in the futures market were promptly met, extensive borrowings were needed to overcome the continuing stresses on other institutions.

The Commission has not requested direct legislation that pertains specifically to these concerns. Rather, the Commission has addressed these problems through the rule-making or regulatory process. In this regard, the Commission has adopted or is presently considering several regulatory measures that are designed to reduce the likelihood of repetition of these events.

First, the Commission has adopted rules providing for the implementation of speculative position limits in all commodity futures markets. At present, the Commission is reviewing contract market proposals concerning the level of these position limits for individual contract markets. The Commission believes that reasonable speculative position limits, if they had been in place from the start and prior to the accumulation of the large speculative positions in silver during 1978 and 1979, would have inhibited the accumulation of the observed large positions and the resultant effects created when the holders of these positions demanded delivery on expiring contracts or exchanged their futures for cash silver. To supplement its adopted speculative position limit rules, the Commission has, however, proposed enactment of legislation that would confirm the authority of exchanges to set speculative position limits. In addition, the proprosed legislation would explicitly confirm the Commission's authority to establish speculative position limits through rulemaking and provide that position limits established by the exchanges could not deviate from limits set by the Commission without the Commission's approval. Finally, the proposals would affirm the Commission's right to enforce all speculative limits including those set by the exchanges.

Second, the Commission has adopted certain rules that change the financial requirements of FCMs. Although a number of rules were adopted that relate directly to the silver experience, one particularly relevant rule in this regard places restrictions on the use of physical commodities as collateral for loans where the proceeds are used to margin long futures positions. During the silver episode, Hunt interests used physical silver acquired through the futures market as collateral for loans from certain FCMs in order to finance the acquisition and maintenance of their futures positions in silver. However, in the face of rapidly declining silver prices during late March 1980, the corresponding sharp decline in the value of this collateral in combination with the inability of certain members of the Hunt family to satisfy margin requirements created considerable financial stress for the affected FCMs.

Third, the Commission has recently approved a request by the industry to establish a National Futures Association. Among other functions, the Association would conduct field audits of FCMs to assess their financial positions. The information acquired by the Association would be shared with the Commission. Accordingly, if the industry's efforts to establish this self-regulatory association are successful, this action may well enhance the Commission's ability to ensure compliance by FCMs with CFTC financial requirement rules, particularly during periods of rapid price movements such as those experienced during the silver episode.

Fourth, the Commission is presently considering various rules designed to address problems related to securing additional information on the futures accounts of foreign traders. During the silver episode, the Commission experienced difficulties in obtaining reliable information on large silver futures positions held by certain foreign traders. Although a clear need exists for changes in regulatory policy toward foreign accounts in this regard, the need for additional information must be weighed against potential adverse effects of regulatory action in this area, including potential negative market impacts associated with reduced foreign trader participation and the possibility of retaliation by foreign governments against U.S. traders. Accordingly, careful consideration of the available regulatory alternatives is necessary before the Commission implements specific rules that address this problem. Nevertheless, the Commission is scheduled to consider this issue at a public meeting later this month.

6. Is there any evidence that financial futures markets are dominated by speculators? If so, are these markets meeting the public interest test?

Although the Commission has designated 27 interest-rate futures markets since 1975, three of the first such markets designated—the CBT GNMA market, the CME Treasury bill market, and the CBT Treasury bond market—currently account for over 86 percent of all interest-rate futures trading activity. Accordingly, Tables I and II refer to the amount of hedging in these three principal markets on December 31, 1981. Table I shows long and short large reporting trader hedge positions as a percentage of total open interest for each of the markets, while Table II shows estimated total long and short hedge positions.

These data show a substantial amount of hedging in interest rate markets. Even though speculative (non-hedging) positions constitute a greater share of the open interest, the total estimated hedging in interest rate markets compares favorably with estimated hedging in traditional futures markets. The average total estimated long and short hedging percentages for the three principal interest rate markets, at 17.5 and 31.9 percent, respectively, fall somewhat short of the estimated average total long and short hedging percentages calculated for a recent period for all of the most active futures markets—24.4 and 44.3 percent, respectively—but interest-rate futures markets are a comparatively recent innovation. Further, some agricultural futures contracts have hedge participation patterns similar to those described above for interest rate futures markets.

Regulatory and other institutional barriers to futures trading (e.g., bank accounting regulations and state insurance company regulations) have also forestalled hedging in financial futures by certain classes of potential users. Nevertheless, as indicated by information from large traders and special surveys conducted by the Commission, major commercial participants in interest-rate futures markets have included securities dealers, large commercial banks, mortgage originators, and other financial as well as non-financial firms. Moreover, in July 1981, the Federal Home Loan Bank Board approved regulations that significantly expand the authority of federally chartered savings and loan associations to use interest rate futures to reduce their exposure to the effects of interest rate fluctuations. Previously, regulations limited federal S&Ls to the use of GNMA futures only, and restricted the level of their use as well.

On the basis of the above types of information regarding market participants, the Commission believes that the interest-rate futures markets meet the public interest hedging criterion under the Commodity Exchange Act.

The Commission recently reviewed available information on other public interest aspects of financial-futures trading in its recent Section 21 Report to the Congress. Studies published to date tend to support the position that financial-futures trading has not adversely affected the cash markets for the underlying securities. In addition, neither the Federal Reserve Board nor the Treasury Department in numerous recent comments to the Commission pertaining to proposed and existing futures markets for government securities, has suggested that these markets have adversely affected the government's ability to manage the public debt.

TABLE I.—HEDGING COMMITMENTS REPORTED [1] BY LARGE TRADERS FOR MAJOR INTEREST-RATE FUTURES, DEC. 31, 1981

Market	Total open contracts	Percentage of total open contracts held by large traders			
		Total reported		Reported hedging	
		L	S	L	S
CBT–GNMA	77,246	65.1	74.6	15.7	22.7
CME Treasury bills	30,069	45.0	56.1	15.9	35.9
CBT Treasury bonds	221,690	51.3	61.6	11.6	26.8

[1] At the time this data was collected, reporting levels established by the CFTC for these markets were: GNMA 100 contracts, Treasury bonds 100 contracts, and Treasury bills 25 contracts.

Source: Commitments of Traders, CFTC, December 31, 1981.

TABLE II.—ESTIMATED [1] TOTAL PERCENTAGE HEDGING COMMITMENTS FOR MAJOR INTEREST-RATE FUTURES, DEC. 31, 1981

Market	Estimated hedging as percentage of total open contracts	
	L	S
CBT–GNMA	17.4	22.8
CME Treasury bills	20.2	42.1
CBT Treasury bonds	14.8	30.7

[1] Traders who own or control futures positions at or above certain levels specified by the Commission are required to file reports classifying these positions as hedging or speculation. Total positions classified as hedging were obtained by adding reported positions to an estimate of hedging positions which are held by non-reporting traders. These latter estimates were derived by using a method first employed for this purpose by David J.S. Rutledge, Associate Professor of Economics, Macquarie University, Sydney, Australia, while a visiting Associate Professor at Stanford University. (See Food Research Institute Studies, XVI, No. 3, 1977-78, pages 205-211.)

7. What effect do stock market indices futures have, if any, on the capital formation process?

The primary sources of equity capital expansion are retained corporate earnings and funds derived from new issues. Equity trading in the "secondary market" for previously issued stock aids capital formation indirectly by providing a post-issuance means of buying or selling outstanding shares. It is expected that stock index futures will likewise aid capital formation indirectly, principally by providing a method for hedging against adverse price changes in securities portfolios or dealer inventories, and in such activities as block-positioning and specialist services.

It is highly unlikely that a person who would invest in the capital formation of a specific firm would substitute an investment in a broad based index. Increasingly, stock purchasing (both new issues and secondary market transactions) are highly selective, and are governed by an assessment of the company's prospects, including its ability to "out-perform" the market as a whole. A broad-based stock index does not provide this opportunity; and when this is coupled with the fact that futures contracts also present different risk-return characteristics and the potential for more frequent margin calls it is difficult to surmise that there is a great deal of inherent substitutability between individual equity transactions and a broadly based equity index future.

Indeed, where the issue of diversion of funds from derivative cash markets has been raised with respect to financial futures and stock options–both types of contracts based on single or a few closely related securities–there has been no evidence produced to support a conclusion that trading in such instruments has adversely affected the underlying cash markets. In light of the currently available, although somewhat limited, research on the diversionary effects of financial futures trading, the Section 21 Report to Congress on financial futures (completed in May 1981) concluded that the research on financial futures trading completed to date had identified no negative impacts on the underlying cash markets. Further, the Treasury/Fed Reserve study of financial futures markets, completed in May 1979, concluded that it would be difficult to attribute any reduction in spot trading in Treasury securities with certainty to futures trading. In addition, a 1974 study of the effects of stock-option trading on the secondary markets for individual equities found that the relative volume of trading of an underlying stock since the Chicago Board Options Exchange began corresponds to that prevailing before CBOE.

In summary, it appears that a stock index future will be most useful to those who already own or manage large, diversified stock portfolios or large quantities of stocks affected by broad market trends. Thus, since a futures contract on an index is expected to provide a risk management tool which will enhance the functioning of the secondary market, its net effect on the capital formation process should be beneficial.

8. If futures exchanges are essentially self-regulating, precisely what does the overlay of a second level of Federal regulation provide in the way of protecting the public and ensuring the smooth function of the futures market?

Prior to the enactment of the Commodity Futures Trading Commission Act of 1974, primary responsibility for the prevention of abusive trading practices and the protection of the public in commodity futures trading rested with the exchanges. The inadequacy of this self-regulatory approach was made evident in the Congressional hearings leading to the enactment of the 1974 legislation. For example, the House Committee on Agriculture concluded that: "[s]elf-regulation ... cannot continue to function [in the futures industry] without a strong Federal regulatory umbrella over self-regulatory activities of the industry. Self-regulation cannot be permitted to be a barrier against public policy and the interest of the American public." H.R. Report No. 975, 93rd Cong., 2d Session 48 (1974).

Accordingly, the Commodity Exchange Act provides the Commission with considerable authority to oversee the self-regulatory efforts of the futures exchanges to assure that the public is protected and that the markets function in a fair and orderly manner. In particular, this federal regulatory presence assures, among other things, that:

(1) through the Commission's designation authority (Section 5, 6) only those futures contracts which meet the Act's test of economic purpose, including not being contrary to the public interest, will be traded on futures exchanges;

(2) as a result of the Commission's rule review and alteration authority (Sections 5a(12) and 8a(7)), the futures exchanges adopt and maintain only those rules which do not violate the Act, which are consistent with the public interest reflected in the antitrust laws and which endeavor to take the least anticompetitive means of achieving the objectives of the Act, or which otherwise are necessary or appropriate to protect persons participating in or affected by the futures markets;

(3) through the Commission's exercise of its investigation, inspection and prosecutorial authority (Sections 5, 5a, 6(a), 6a, 6b, 6c, and 8), the exchanges fully enforce (Sections 5a(8, 9)) their trading, financial and other rules which are approved or otherwise made effective by the Commission and that the exchanges otherwise remain in compliance with the requirements of the Act and the Commission's regulations thereunder; and

(4) through its review authority (Section 8c), exchange actions to deny access to the futures markets or otherwise discipline or sanction their members are taken in accordance with the policies of the Act.

These examples are not meant to be exhaustive of the Commission's authority to assure that self-regulation by the exchanges is both effective and consistent with the objectives of the Act, but only to provide a sketch of some of the more important ways in which the Commission exercises its critical oversight role. The Commission's oversight, we believe, has contributed to a marked improvement of exchange self-regulation over the past seven years. But the public's confidence in the futures markets today remains based upon the assurance of Commission oversight, coupled with exchange initiatives.

Some people have questioned why it is necessary for a person who is subject to a disciplinary action by a self-regulatory organization also to be subject to possible sanctions by the Commission. There are a number of reasons. First, the conduct considered by the self-regulatory organization may also involve violations of the Act and the Commission's rules as well as the organization's rules. The organization, however, must necessarily limit its disciplinary action solely to the violation of its rules, and thus not address the full extent or seriousness of the violative conduct.

Second, only the Commission has authority over all participants in the futures industry, regardless of the current status of their membership in one or more self-regulatory organizations. For example, a person subject to a sanction by one self-regulatory organization might avoid effective imposition of the sanction merely by terminating its membership. In contrast, no one can resign from the reach of the Commission's enforcement authority. Moreover, the Commission's arsenal of enforcement weapons is more potent than that of any one self-regulatory organization. For example, in an appropriate case, the Commission may order that an offender cease and desist from unlawful conduct anywhere, not just on a particular exchange. Similarly, the Commission can deny trading privileges to the wrongdoer on all exchanges and can revoke the offender's license to do business with the public anywhere.

Finally, the Commission believes that offenses of comparable seriousness should result in sanctions of comparable weight and deterrent value. The Commission's authority thus provides standby assurance that sanctions imposed by self-regulatory organizations will have comparable effects upon offenders.

9. I understand that it has been suggested that the imposition of user fees by CFTC be deferred now, and the situation be reevaluated after the National Futures Association has been fully established to handle the futures regulatory functions assigned to it.

What are the pros and cons on this course of action? And what is the Commission position on it?

The proponents of such an arrangement insist that insofar as the National Futures Association will save Commission resources, the Commission does not need a user fee. The Commission believes that this argument is flawed in several respects.

First, a user fee would not represent a source of additional Commission funding. Because the fees would be paid to the Treasury, the Commission would still be subject to the normal budget and appropriations process. The user fees would be, at best, an "offset" to the Treasury for funds actually appropriated to the Commission. The premise of user fees is that the persons who receive the greatest direct benefit from futures trading should bear a proportionately greater share of the cost of regulation of that activity than is borne by general taxpayers.

Second, NFA was designed to supplement and complement the Commission's activities. Although a fully operational NFA could assume some of the Commission's responsibilities (e.g., the processing of registration applications), other activities—ranging from the actual denial of registration to reparations and the designation of new futures contracts—cannot be delegated to an industry-wide self-regulatory organization.

Finally, one of the principal purposes of NFA was to extend to the entire industry the principles of self-regulation (which are presently applicable only to exchange members), to allow the Commission to assume more of an oversight role in the review of industry self-regulatory activities and to enable the Commission to allocate its existing resources to those functions, such as enforcement of the Act, which must be performed by the Commission.

If the industry allows NFA to founder, the Commission will have no alternative which is consistent with its statutory mandate to ensure fair and honest dealings in the nation's rapidly-expanding futures markets other than to request still greater levels of funding and additional resources in order to increase the level of direct government regulation in the absence of comprehensive self-regulation by the industry. Indeed, if NFA does not become fully operational, it might become necessary for the Commission to exercise its authority under Section 17(d) of the Act (7 U.S.C. § 21(d)) to assess those firms and individuals who are not members of a registered futures association in order to defray the costs of the additional regulatory duties which are required to be performed by the Commission in the absence of a functioning futures association.

Moreover, the fiscal promise that NFA may hold for the Commission's budget is unlikely to be realized anytime soon. In the meantime, the Commission must plan for fiscal year 1983 and beyond, which may include possible budget cuts, even as the industry, and thus the Commission's oversight responsibility, grows dramatically. This dilemma is nearly unsolvable, absent the relief of a user fee.

The Commission therefore does not agree with the efforts of some to link the survival of the National Futures Association to the defeat of user fees and, accordingly, opposes any attempt to hold NFA hostage until a plan for user fees is deferred or abandoned.

Thus, while the Commission favors a continuing user fee system for the years ahead, a possible temporary measure to await review of the NFA's development would be to adopt the user fee system for a limited time, such as two or three years, and to reserve judgment on making the fee permanent until the NFA's effectiveness can be assessed. This would provide the immediate fiscal relief that the Commission needs, short of the establishment of a permanent program. At the same time, it would serve as a compelling inducement to the industry to develop and support a truly effective NFA on an expedited basis.

Sincerely,

PHILIP MCBRIDE JOHNSON, *Chairman.*

COMMODITY FUTURES TRADING COMMISSION REAUTHORIZATION

MONDAY, MARCH 1, 1982

U.S. SENATE,
SUBCOMMITTEE ON AGRICULTURAL RESEARCH
AND GENERAL LEGISLATION OF THE
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, D.C.

The subcommittee met at 9:35 a.m., in room 324, Russell Senate Office Building, Hon. Richard G. Lugar (chairman of the subcommittee) presiding.

Present: Senators Lugar, Dole, Hayakawa, Boren, and Heflin.

STATEMENT OF HON. RICHARD G. LUGAR, A U.S. SENATOR FROM INDIANA

Senator LUGAR. This hearing will be called to order.

This is the second of 5 days of hearings on the reauthorization of the CFTC. We are pleased that our initial witness this morning would be Mr. Leo Melamed, president of the National Futures Association.

Will you come forward to the table? We welcome you to the committee hearing this morning. You have had a long and distinguished career in this industry that we are presently examining.

Without further comment, I would like for you to proceed with your testimony and then Senator Heflin and others will join us.

STATEMENT OF LEO MELAMED, PRESIDENT, NATIONAL FUTURES ASSOCIATION, ACCOMPANIED BY PATRICIA CARLILE, ACTING EXECUTIVE DIRECTOR, AND JOHN STASSEN, GENERAL COUNSEL

Mr. MELAMED. Thank you, Mr. Chairman, Senator Lugar, members of the committee. As indicated, my name is Leo Melamed. I am chairman of Dellsher Investment Co., special counsel to, and a former chairman of the Chicago Mercantile Exchange, and since 1976 an organizing director and president of the National Futures Association. I am delighted to appear before you today on behalf of NFA, the National Futures Association.

Joining me at the witness table are Patricia Carlile, NFA's acting executive director, and John Stassen, a partner of Kirkland & Ellis, NFA's general counsel.

Mr. Chairman, I prepared a lengthy written text which I will not read, as well as some by way of separate documents—these two books—which are presented as part of these proceedings and I request that the chairman accept them as such.[1]

Senator LUGAR. Without objection, they may be made a part of the record.

Mr. MELAMED. What I intend to do with my time hopefully is to advise this committee of the National Futures Association, acquaint you with the history of this association, its purpose for existence, the benefits we believe that it offers to the futures industry, the CFTC and the U.S. taxpayer, why its existence is presently threatened and why we believe that the NFA is the correct alternative to the budgetary concerns of the CFTC.

If I may, I would like to begin at the beginning with the genesis of the NFA. As you might recall, the NFA was conceived by the Congress back in 1974 when it adopted the Commodity Futures Trading Commission Act, and under title III thereof provided for the birth of an industry self-regulatory association.

Two years of incubation followed that inception, and in 1976 fertilization occurred when some of the leaders within our industry organized and filed under the corporate laws of the State of Delaware the National Futures Association.

What followed was probably the longest and most difficult period of gestation ever recorded in private sector embryology. Five years it took for this organization to get to the point where it could file before the CFTC. During these 5 years, the birth of this entity was always in doubt. The reasons for that is that not everyone wanted such an institution, such an entity, nor did everyone believe that it was a worthwhile effort. We had antagonists from both within and without the industry. The antagonists from within the industry claimed that NFA would represent but one more layer of regulation in a world already filled with many such regulatory entities, that the NFA could not and would not fairly represent the industry, that the NFA would in fact be too costly to ourselves. And finally some cynically questioned why we should regulate forcibly and well in areas where the CFTC had failed to do so.

From without, the antagonists simply stated that the NFA was but a ruse to divert some of the authority away from the CFTC and besides, they said, one could not trust the private sector to self-regulate in any event.

The protagonists for NFA were also from within and without the industry. They believed they were more far-sighted and far more responsible. They argued forcibly that the industry could be safe from unnecessary duplicative regulations by the NFA, that the NFA represented in fact the next logical step of unification in the life of the futures industry, that it could carry out regulatory functions in a more proficient manner; after all, it could utilize expertise that it knew well, was right around it and within the industry. It could relieve the CFTC of some obligatory burdens so that it could do a better oversight job in areas that it had failed to expeditiously do so. It could also prevent, they argued, the onerous onslaught of those who propose user fees for the industry. But outside of these specifics, the NFA protagonists argued with what amounted to perhaps religious fervor that the NFA was consistent with the self-regulatory banner which this industry had proudly hailed for over 100 years.

---

[1] See p. 322 for the prepared statement of Mr. Melamed, and p. 330 for an extract from one of the books furnished for the record, the balance of which has been retained in the committee files.

The protagonists won and in March of 1981 they filed an application before the CFTC for designation as a futures association under section 17. The NFA was devised to do the following things:

To effectively police the futures industry itself, as well as those segments operating outside the system of exchange standards and surveillance;

Achieve better cost control over regulatory expense by eliminating duplication and conflict between governmental and self-regulatory programs; and

To facilitate a reduction in the costs of Federal regulation for the benefit of taxpayers in general and market users in particular.

A lengthy and exhaustive but constructive review process followed this application before the CFTC and finally, on September 22 of last year, the NFA was designated an official registered futures association. Indeed, the baby was born.

The NFA went ahead with plans to implement this organizational effort. Large sums of money were committed to the project and on December 15, Pat Carlile beside me here was named acting executive director. We then hired a corps of full-time professionals to develop programs and systems for membership qualification, membership registration, FCM financial audits and standard compliance programs. National headquarters was opened at 120 South Riverside Plaza in Chicago, industry was advised of the timetable for membership and events, the agenda for a full briefing was prepared for the Futures Industry Association convention this March, and plans for a full 40-person board to represent every segment of the industry was instituted.

In short, we were prepared to meet the goal of being a significant self-regulatory factor for our industry by October 1 of this year. If allowed to carry out our program, we will provide enhanced customer protection and more efficient regulation at over one-third less cost to the taxpayer.

We propose to enhance regulation by assuming the following obligations: Comprehensive FCM audits and oversight; Introducing broker oversight and ethical standards; Pool operator and trading advisor oversight and ethical standards; Sales practice reviews; Options program oversight of FCM's and introducing brokers; Registrations and fitness standards for industry professionals; Speedy, inexpensive, equitable customer claim procedures; and Enforcement of ethical rules on all industry professionals.

In addition, we propose an emphasis on self-regulation by the Nation's 11 commodity exchanges through streamlined exchange rule-approval procedures; streamlined market designation procedures; giving exchanges front-line responsibility over speculative limits; and avoidance of duplicative and redundant programs, including surveillance and enforcement efforts.

If implemented, NFA estimates that it will permit the CFTC to reduce its staff levels by at least one-third and result in a substantial reduction of its 1983 budget request, and we believe something like a $7 million reduction in its 1982 budget.

But, Mr. Chairman, as you know, a large cloud hangs over NFA. Suddenly its very life is threatened even before it can justify its existence, even before it can produce the benefits it was programed to do, even before it is 1 year old.

The NFA program—in fact, its very essence—is threatened by the CFTC's recent decision—supported by OMB—to propose a special regulatory tax on all futures market participants, including hedgers and market makers.

Mr. Chairman, members of the committee, I am here to plead for the life of NFA and to impress upon you why the enactment of the CFTC tax is unnecessary and incompatible with the premises on which the NFA was created.

The CFTC's tax would deprive the NFA of its funding base, destroying the underlying reason for its creation, that is, to absorb some of the regulatory burdens in a cost efficient manner, and it would remove the single most effective incentive of a self-regulatory organization, which is to prevent duplicative, oppressive regulation. Our industry simply cannot be expected to pay twice for the same regulatory process. It makes little sense for our industry to fund a self-regulatory organization if the CFTC plan is enacted.

The CFTC Chairman, Phil Johnson, is and has been a protagonist of NFA. I know because I worked with him personally during 5 years of its difficult gestation period. But he is in error today when he says that proponents arguing abandonment of NFA if a fee system is adopted are largely the same people who earlier opposed NFA for other reasons.

Members of the committee, I represent one of seven organizers of NFA who toiled against bitter odds to give birth to this entity, and I am here to respectfully advise you that we cannot in good conscience tell our industry members that NFA represents the same purpose, the same promise, the same productive results if the CFTC tax system is imposed.

John Marshall some time back said that the power to tax involves the power to destroy. That is clearly the theme and view of the present administration. President Reagan has repeatedly spoken out against burdensome taxation and its destructive force on the private sector. He set the tone for the administration during his state of the Union address when he said that his plan for recovery was to remove unnecessary regulation in order to spark productivity.

Moreover, both Republicans and Democrats of Congress alike have gone on record against excessive regulation and to urge a system of self-regulation in its place wherever possible.

A futures transaction tax proposed by the CFTC is not merely perverse in economic terms and dangerous as an incentive for growth of Federal buraucracy and economic regulation, it represents the very anthesis of the agreed-to theme by both the administration and Congress.

Now, I want to impress the following upon you. I understand that no industry wants user fees, but ours is not an instance when an industry is shirking its responsibilities. Quite to the contrary, the futures industry is exemplifying the finest tradition of participation in the burden of government. We are prepared, willing and capable of sharing the regulatory burden and costs which we estimate will be somewhere between $6 and $8 million to our industry annually, if given a chance. We are not prepared, however, to duplicate these costs with the CFTC tax

We submit that if the NFA is allowed to function, if our recommendations as submitted here today are implemented, then there is no reasonable or proper fiscal rationale for the imposition of a special regulatory tax on futures transactions. Rather, we agree with Commissioner David Gartner when he recently said that the NFA represents an organization which will be totally funded by the industry itself to the tune of millions of dollars annually and the NFA will take over many of the functions performed by the Commission. Having mandated the NFA, Commissioner Gartner said, I do not believe that the Commission should place an additional burden on market users by way of the transaction tax.

Through NFA the Federal Government will accomplish significant cost savings and advance its cause in favor of deregulation and on behalf of self-regulation. To put it precisely, Mr. Chairman, NFA is the self-regulatory, deregulatory answer to increased CFTC budget demands in an era of diminishing Federal resources. NFA is an answer which cuts the taxpayer's costs significantly but actually enhances the level of quality of customer protection. It is the answer which requires no new taxes. It is the alternative which this Congress ought to adopt.

I will not go through the specifics, as I said, because I have submitted them formally for the record. So in closing I would like to point out the following:

I would like to underscore that the U.S. futures markets have long functioned in the interests of producer and consumer alike. In agriculture, they have contributed immensely to its price stability, price insurance, price discovery. It is a fact that we are still the only nation in the world that has an abundancy in food products. Our agricultural system is still the envy and marvel of the rest of the world, and these futures markets have been an integral part of this marvelous system for over 100 years.

Futures markets indeed represent some of the oldest institutions in our Nation. The youngest major market is over 50 years old, the oldest over 150 years. Few institutions in the Western World can make that statement. Obviously, these institutions were in existence long before there was a CFTC. Their longevity is based on a tradition of self-discipline and self-regulation. Few institutions can boast as we can that not $1 of public funds was ever lost as a result of a financial failure of one of its member firms. This enviable record was compiled through a system of self-imposed internal discipline by the members themselves long before there was a CFTC.

Recently, as you know, these same markets have shown innovation which is again the envy of the rest of the world. They have instituted the so-called financial futures to serve the business community as they have served agriculture for over 100 years. Again, this was instituted before there was a CFTC. Financial futures have swiftly become a valuable asset and an indispensable tool for the business community and money managers. They represent considerable benefits to a business world in a time of double-digit inflation and volatile interest rates such as we have witnessed; thus these markets have shown an ability to meet the need of the times, Mr. Chairman, as well as a long tradition of self-discipline and self-regulation.

The NFA is proud to offer to join in this tradition. Finally, I need not remind this committee that our economic system and our social system, our political system as well, are already staggering under the excesses of those who trust government regulation and distrust freedom. Of late, however, there seems to be general recognition that this country and Congress must move in the opposite direction, in the direction of lessening the burdens of regulation.

The CFTC bill, however, including its tax plan, is a giant step in the opposite direction of this new trend. I do not believe that the members of this committee will want to add to the burdens already imposed on our free and functioning futures markets by supporting such legislation. NFA respectfully urges this committee to accept its alternative, an alternative which is the only sensible and certain means to bring down the costs and burdens of Federal regulation while at the same time assuring that the public interest is well protected.

Thank you for the time. I will be happy to respond to any questions.

Senator Lugar. Thank you very much, Mr. Melamed.

In order to have as complete a record as possible, I would like to ask two general questions to begin with before going specifically to your testimony. First of all, Mr. Melamed, do you believe the CFTC should be reauthorized?

Mr. Melamed. Yes, I do.

Senator Lugar. Second, is NFA generally supportive of the jurisdictional agreement tentatively worked out between the Commodity Futures Trading Commission and the Securities and Exchange Commission by Mr. Shad and Mr. Johnson?

Mr. Melamed. The NFA has taken no stand on this issue, as it is not directly affected by it.

Senator Lugar. Third, in the final paragraph of your testimony, you asked for the committee to take the alternative that NFA is presenting as opposed to the legislation that is before the committee presently. That alternative, as I understand it, is not a separate piece of legislation, or is it, and in what ways would it differ from the basic piece of legislation we are considering?

Mr. Melamed. It is not a separate piece of legislation. There are, however, recommendations that we have submitted which will add to what the act already allows and give us additional regulatory authorities to carry out those functions that we feel are necessary in order to save the burden from the CFTC.

Senator Lugar. Specifically you have suggested legislation that is required for implementation of the NFA idea?

Mr. Melamed. Additional legislation, yes, sir.

Senator Lugar. Mr. Melamed, the burden of your testimony dealt with the thought of the user tax which is a part of the underlying legislation that the CFTC has suggested as opposed to an NFA as if these were necessarily separate notions or even in some opposition to each other. Is this necessarily so? And why has the NFA taken such a strong position that leads this subcommittee to a feeling that it is either one or the other? Why not both?

Mr. **Melamed**. Sir, the single most important incentive for this industry to have finally forged an NFA was to prevent duplicative regulation and to stave off user fees. Indeed, for 5 years we carried that banner throughout every corner of our industry, saying that the most responsible thing this industry could do was to charge itself to carry out a regulatory function that is authorized under title III of the act and as ordained by the CFTC when it proclaimed it as a futures association regulatory agency.

To go back to that same industry now and to say all that we said for 5 years is no longer so, that we should do this in addition, you will be taxed so that the CFTC could carry out additional regulatory burdens as well in a duplicative manner which is bound to be created, is just an impossible thing. It makes us out to be liars indeed and it is a destructive way to proceed for our industry. We cannot in good conscience do both.

Senator **Lugar**. Well, I appreciate the arguments that have been made by the industry. I suppose one of the problems that Congress faces now is attempting to move toward a balanced budget. The problem comes in how to finance the CFTC as to whether the incidence of that finance ought to occur primarily with people who are benefiting in the industry, quite apart from the values that we understood the industry's self-regulation. This is what leads me to the question: If in fact the industry understood that the user tax was to be simply and primarily a way of financing the basic CFTC, would the same criticism of you and others who have been advocates still rebound all around your heads and shoulders, in other words, it simply is not your fault that Congress decided to finance regulatory agencies, and this would not be the only instance by user fees, it just simply is a financial necessity that the President and OMB and maybe this committee, maybe Congress will see arguable.

The NFA idea I had thought was one in which the industry wanted to give assurance to the public as well as to the Congress that its affairs were in order, that the extension of enforcement went broader and wider. Given this context of how we are going to meet our budgetary requirements as well as the confidence of the industry needs, would the opposition of all members of the industry continue to be this adamant to the user fee idea?

Mr. **Melamed**. May I make the following point, Mr. Chairman, that it is the NFA's view that it can save at least one-third of the staff levels of the needs of the CFTC as well as many millions of dollars from its budget by assuming the burdens that it has offered to do, that it could do them better, that it can do them more efficiently, and that it can do them in line with what is the theme of this administration and this Congress in favor of self-regulation.

It is not a case where we believe that a fee system is needed for the CFTC to carry out its burden. It is a case where we feel that we can charge ourselves and do it more efficiently and still carry out the same burdens in a better manner.

Therefore, we feel that we can reduce the budgetary needs of the CFTC, rather than what the CFTC is suggesting has to be done.

The second point I would like to make is that this is not simply a user fee suggested as it would be in the case of someone's yacht or someone's private airplane. Sir, we are imposing, if we follow the CFTC plan, a tax system on users, that is, risk takers of the marketplace. Are we then suggesting that the Federal Government is doing a service to a risk taker for taking the risk and assuming the risk from a hedger?

On the contrary. The risk taker of the United States is welcome to these markets because he is needed. Without him, we cannot work this system of price insurance. We need the risk takers. We give them no privilege. We invite them to use their money so that they can assume the risk that they are ready to from hedgers and market users of this agricultural system as well as the business system. And thus there is no similarity between that kind of a fee system and a fee system that is normally considered a user fee system.

So that for both reasons, sir, we feel that we can save the budget from the CFTC and do exactly what the Congress wants done.

Senator **Lugar**. Senator Heflin, do you have questions of the witness this morning?

Senator **Heflin**. Yes; thank you. I notice that the NFA is prepared and willing and capable of sharing the regulatory burden at a cost estimated at $6 to $8 million annually if given the opportunity to do so. Now, you do not want to duplicate those costs is what you state. Basically what is the total amount of money that the user fees would bring in if we gave you the figure of anticipated revenues that the proposed user fees would bring in?

Senator **Lugar**. Six cents and 12 cents round-trip, 100 million contracts last year, so it would——

Senator **Dole**. I think they said $15 to $16 million the other day.

Senator **Lugar**. That is at least my recollection of Phil Johnson's testimony, about $15 or $16 million.

Senator **Heflin**. In other words, under the NFA you feel that $6 to $8 million or half of that could be—the NFA could, by its plan, prevent duplication?

Mr. **Melamed**. More than that. Our fee system would charge our own industry $6 to $8 million. I assume it will be $8 million. And we believe with that $8 million, because we can do it more efficiently, we can save the Government a lot more than the equivalent of $8 million. We feel that the savings will be even in excess of that, perhaps around $10 million.

Senator **Heflin**. What is the present budget for the CFTC?

Senator **Lugar**. I would have to ask the staff if anyone has any idea.

Mr. **Melamed**. About $20 million.

Senator **Lugar**. I understand the new budget would be $23 million for fiscal year 1983; $23 million is roughly the ball park for the current year.

Senator Dole, do you have questions of the witness?

Senator **Dole**. We have three committee meetings all starting at 9:30 this morning, so I am not certain where Mr. Melamed was when I came in. Is it going to cost about $6 million to operate NFA?

Mr. **Melamed**. $6 to $8 million, probably $8 million in its full operating form, about $8 million.

Senator **Dole**. So you subtracted that from $20 million. Are you willing to pay a smaller futures fee, is that what you are saying?

Mr. **Melamed**. No; I'm not, sir.

Senator **Dole**. Oh. [Laughter.]

It is the principle of the thing.

Mr. **Melamed**. Well, it is the principle and it is certainly a principle, Senator Dole, that I think squarely meets with your own ideas. We want to self-regulate and are willing to charge ourselves to do it. We think by charging $8 million to our industry we can do a $10 or $11 million job and we can do it more efficiently and better, and certainly it seems to be the way we ought to go.

Senator **Dole**. I assume some of the CFTC budget is for the public, and the public ought to assume their portion, perhaps 20 percent or 30 percent. I guess the $16 million would be what somebody has determined the industry should pay. We have grain inspection fees and meat inspection fees and we are asked to impose or to legislate a number of other fees such as airport, airways and even charging for maps and small items. If somebody benefits, particularly in a time of self-regulation, then the principle is sound.

I am just trying to see if there is any flexibility at all in your position. We went through this last year in a different area and I didn't find any flexibility, but this is a different issue. You are paying enough now to pay for the CFTC through the staddle legislation, I think, for the next 5,000 years. [Laughter.]

Mr. **Melamed**. I would rather leave that one.

Senator **Dole**. Right.

Mr. **Melamed**. This is an instance, however, where we are willing to meet the cost of regulation and to fund a certain amount, a large amount if I may, through a system of fees, self-regulatory fees of the industry to do this job. It is not an instance where we are ducking it. It is not an instance where we are throwing up our hands and saying we don't want to be——

Senator **Dole**. Will that be a transaction fee or——

Mr. **Melamed**. It will be similar. It will have the same funding base. The members themselves will be charged in just the way the CFTC proposes, but the same funding base exists. And simply stated, we feel that we are going more than a measure toward helping in the regulatory burdens that you are talking about, that other industries get taxed upon, and we are doing that, but we think we can do it in a better way and we think that we can do it in a more efficient way.

We are suggesting simply that the CFTC is asking for a budget that clearly is duplicating what we intend to do, and it is toward the public in the areas that we offer to do. Regulation of FCM finances deals directly with the public. This is where many of the problems occur in nonmember FCMs, and that is the job primarily that we are willing to do.

Also in customer arbitration, in customer proceedings of reparation, we have offered amendments to change the rules so that we can do that whole area and undertake those regulatory responsibilities. Presently, if a customer complains under reparations, I believe it can take anywhere from 3 to 4 years before the claim is adjusted. We believe we can do that within 1 year's time, rather than 4.

And so it is with respect to public participation that we are talking about, taking over those regulatory burdens.

Senator **Dole**. Would it be fair to summarize what you have said, that as far as you are concerned, the NFA is concerned, that you are willing to assume the obligations for self-regulation, which is going to be in the neighborhood of $6 to $8 million, and either the CFTC budget should be reduced by that amount or that any additional requirements for the CFTC which properly should be charged to the public if they avoid duplication and a lot of the other things you suggested?

Mr. **Melamed**. As part of the general taxation system, yes, sir. One more thing, in that we believe that if you gave us a chance, you the Congress, we could prove our case. We can't prove our case if we start out in this manner, but we can prove our case in a number of short years if you give us the chance to do so.

Senator **Dole**. Could you do it in a year?

Mr. **Melamed**. A couple of years.

Senator **Dole**. A year and a half?

Mr. **Melamed**. Two. [Laughter.]

Senator **Dole**. I'm getting close. Thank you.

Senator **Lugar**. Thank you, Senator Dole.

Mr. Melamed, it is not the purpose of the Chair or certain Senators to badger you on and on about this fee, although you will have to admit that it does have a central point in your testimony this morning and you have drawn our attention to that controversy.

I suspect that you have been involved in this futures business for so long and the organization of the industry and almost are a philosopher of the whole process. This is why I am bold enough to try to think along with you this morning. It occurs to me that the early testimony that we have seen, some of it delivered, some of it will be, hearings going on in other forums indicate that the futures industry has very remarkable prospects ahead of it largely because people of some probity as well as foresight traded some exchanges, some markets that are truly remarkable. The CFTC has been furthering this by okaying additional contracts, ways in which markets can be created, and the whole market system has been invigorated.

Now, the problem that many people see, of course, in all of this is that we are having a dynamic escalation of activity, of contracts, of persons who are involved in this, persons who are affected by it. And a lot of legitimate questions have been raised as to whether the CFTC apparatus is adequate to cover all of these bases.

Now, one way would have been, I suppose, to have not okayed the contracts or to have cut back markets to such a restrictive situation that a relatively few people can look at all of it. That has not been the way that we have been moving, and we come to this reauthorization at a time that the industry, as Mr. Johnson pointed out the other day, is involved in sums that the total amounts of the contract get to a trillion dollars or more, that the brokerage fees of 400-and-some major firms are in the hundreds of millions, and there is a great deal of money involved—not all of it profit, but a substantial amount of money, and considerable concern of the public as to how well in an oversight function this subcommittee and this committee is doing its job.

It may be that the committee will come to the conclusion that $20 million a year or even $23 million is simply inadequate for all the things that we are doing. It may be as a matter of fact, that a great deal more of the CFTC will be required to bring these sorts of assurances.

I would have thought that everybody in the industry, given the prospects for growth and for profits in a very legitimate sense, would be welcoming every possibility for strengthening the proposition, and this is why I am somewhat disconcerted to find that we have a situation in which in the event we perceive a user fee to do our duty as we see it, financially as well as with regard to strengthening the oversight of the industry, that the NFA would disappear or that the people would be totally out of joint in the situation.

I would hope that those who like the industry and look forward to its growth in our system would be for reassuring the public in every possible way, doing so at least with an incidence of fees upon those who most benefit. I think we can have legitimate differences of opinion as to who ought to pay, but it may be that this is a much bigger job than we have had to do before.

How do you envision it? Do we have a bigger job? How much money really is it going to cost to bring assurance to the public as well as to the members? And who in your judgment ought to pay for this?

Mr. **Melamed**. That is a very difficult question, of course, and I would like to respond by saying that you should not have the view that in fact the CFTC budget is the only portion of regulatory activity or cost that goes on in our industry. Of the 11 exchanges, you are talking about millions, literally maybe the equivalent of the present CFTC budget in funds that are provided by the exchanges in helping the system of regulation that the CFTC does not do but that the exchanges carry forward.

Indeed, the exchanges are willing to do more and some of the rules that we have provided to streamline this process and to end some of the duplicative activity between the CFTC and the exchanges would again do exactly what you are suggesting, the burden would suggest, the exchanges would do more.

Those are some of the things that we feel we can do and will do and are willing to do. But one should not get the impression the $20 million of the CFTC budget is the only cost of the regulatory activity because the exchanges are assuming so much of the burden themselves and have done so for over 100 years, as I pointed out.

The other thing that I would like to suggest, as has been suggested before in terms of some form of a compromise or different position, that if we are talking about this issue of whether the NFA can in fact provide the kind of regulatory activity that is needed to do an effective job, could we be allowed to do that for 2 years without the imposition of user fees and give us a test, put it to us—we are offering, we are saying we can do it, by God make us show it. If we cannot show it, we have lost the argument. If we can show it, well then perhaps you will agree with us that we are doing a good enough job that no user fees are necessary.

Senator **Lugar**. Mr. Melamed, if the NFA takes over some of the Commission's registration functions, should a registrant have a right to appeal a NFA decision suspending or revoking registration to the Commission?

Mr. MELAMED. Oh, absolutely. The right of appeal is never removed. The general right of oversight by the CFTC we never suggested should be removed from them.

Senator LUGAR. Why does the NFA seek to bar the States or other governmental bodies from taxing future transactions at the State or local level through an amendment to the Commodity Exchange Act?

Mr. MELAMED. Well, it is the same problem, it is the same funding base. Everybody wants it and we have got to use it where it can most serve the U.S. taxpayer.

Senator LUGAR. Are any State and local governments now levying such a tax?

Mr. MELAMED. None that I know of.

Senator LUGAR. Do you see it as imminent or is it just a general prescription that you are attempting to——

Mr. MELAMED. As everyone is jockeying around for funds, it has already been attempted in the State of Illinois once or twice and it is going to be attempted in other States, and obviously everybody is looking around for a place to hang their hat. We are afraid of that.

Senator LUGAR. Senator Hayakawa has entered the hearing. Mr. Melamed has been testifying, Senator Hayakawa. Do you have questions that you want to direct to him at this point?

Senator HAYAKAWA. I don't know the context of where you were when I came in.

Senator LUGAR. I understand. We were——

Senator HAYAKAWA. I just heard him. It is a pleasure to see you again, Mr. Melamed.

Mr. MELAMED. It is nice to see you.

Senator LUGAR. Let me ask a couple more questions then. Maybe it will give you a little warmup.

Senator HAYAKAWA. Fine.

Senator LUGAR. Then I would be happy to defer to you or other Senators.

Will the NFA be assuming responsibilities for any exchange instruments, in particular leverage contracts or dealer options?

Mr. MELAMED. In dealer options, we have offered to. In leverage contracts, I don't believe so at this point, but dealer options, yes. In fact, that is part of the amendments that we have offered to this committee.

Senator LUGAR. Senator Dole, do you have any more questions?

Senator DOLE. No.

Senator LUGAR. Senator Heflin?

Senator HEFLIN. In the type of self-regulation that is going on right today that you have mentioned, where you are probably spending up to the budget of the regulatory agency, do you—in other words, there are matters in order to regulate and keep the buyer and the seller even, that you have got certain rules that you require that they have to do before they can trade the next day, closing out their accounts?

Mr. MELAMED. Yes, sir.

Senator HEFLIN. And that sort of thing, like that, that is essential.

Mr. MELAMED. Yes, sir.

Senator HEFLIN. Now, what part of the CFTC is in effect user oriented of the type of thing—you know, we speak of users and I think that sometimes we look at user fees and say that people are using a service or activity, when, in fact, they do not really in a sense fall in the category of the definition of user. What percentage of the activity of the CFTC is in effect a user service or activity?

Mr. MELAMED. Of course, that does depend on the definition of user. In its general sense, it is anyone who trades commodities. A user would be by that definition a user who takes a position, he or she takes a position in the market. Obviously that is not what you are referring to. The user as such of these markets, the hedger and the business commercial activity that goes on in these markets depends very heavily on a speculative element, because otherwise it does not have anyone to pass that risk on to. That user, the commercial, the hedger activity is a much smaller portion of the entire pie of users. There are estimates of anywhere between, say, 10 and 20, sometimes 30 percent of the market. I do not have those statistics at hand and I am only guessing.

But the point that I am making is those users, the commercial users of the marketplace, are a much smaller portion of the general users who are taking the risk away from the hedgers. I do not know if I have responded.

Senator LUGAR. Senator Hayakawa, any questions?

Senator HAYAKAWA. I do not understand this tremendous objection, Mr. Melamed, to the user fee which is planned to be set at 6 cents on a transaction. The fee is less than one-third the cost of a postage stamp and even less than the cost of a telephone call, for transactions which involve tens of thousands of dollars or more. It seems to me that 6 cents on a transaction is so trivial from the point of view of the person involved in the transaction. At the same time the cost to the taxpayer in supporting the CFTC is a burden. I don't know why the industry objects to it so much.

Mr. MELAMED. The fees suggested by the CFTC are not merely 6 cents. It is two-tiered. There is 6 cents to the market professionals or traders of the market, and it is a much larger fee to the public generally. The problem with that is not the amount. The problem with it is that it is taxing the same funding base that the NFA is offering to do the same with.

In other words, we are offering to do it and to tax ourselves, we the NFA are offering to tax ourselves in order to carry out similar functions more efficiently, but if we tax that base through the CFTC suggestion we are taxing the same form of money that we want to, and we want to do it on a self-regulatory basis. We are suggesting that our way is a more efficient way and the way through self-regulation that we believe Congress ought to support.

Senator HAYAKAWA. Would you not be charging a good deal more than 6 cents a transaction?

Mr. MELAMED. Our system——

Senator HAYAKAWA. How would you work it?

Mr. MELAMED. Our system would be entirely different—not entirely different, somewhat different. It would involve a fee to futures commission merchants that would be both an annual fee and one as a percentage of the fees that they would have to charge to public users of the marketplace, and in addition the whole system of fees, the CPO's, CPA's and so forth, as well as for those exchanges that become members of the NFA.

If the exchange, for instance, becomes a member of NFA, it would get a certain set fee charge that it would have to pay the NFA. So it is an entirely large complex system of fees, somewhat different than what the CFTC is suggesting, but the same funding base is involved.

Senator **HAYAKAWA**. Thank you very much. That was the principal thing I wanted to ask about. However, I would also like to ask about the approval of rules. The industry would like less CFTC interference in exchange rule changes than the Commission wants. The industry is concerned because in their proposed legislation, the CFTC wants the right of approval over any rule of major economic significance without defining what that phrase means. In addition, the Commission wants the right to subject any rule to the approval process simply by giving 10 days' notice. However, the industry also wants to put time limits on CFTC approved rule changes, an idea that the CFTC opposes. The CFTC claims this would be unnecessary because it rarely takes more than 60 days to approve a rule.

Now, would you explain this controversy here?

Mr. **MELAMED**. Well, it is also an attempt to save some of the money from the CFTC budget, and what we feel are unnecessary long rule reviews that waste a lot of time and a lot of staffing and money that we feel are altogether unconscionable. There are times that rules have taken well over 1 year, 1½ years for approval, and they go through a system of review that borders on silliness. Also the right of the CFTC to review all our rules goes to a point where if we changed the time of the market trading hours we would first have to go through a review before the CFTC.

Now, we are suggesting that the CFTC can save a lot of its staff time and budgetary money if it would allow the exchanges to do some of these things themselves that really do not affect the public integrity of the markets and so forth, and we can do it in a much quicker fashion. So we are suggesting that the CFTC guarantee that some of these things can be done quickly and not spend as much time as they are presently doing on them.

Senator **HAYAKAWA**. Thank you. In your testimony you suggest that the CFTC should surrender significant regulatory responsibilities over to your organization.

Mr. **MELAMED**. That is correct.

Senator **HAYAKAWA**. Assuming the CFTC agrees to give you the desired responsibilities, how much money would you estimate the CFTC would save?

Mr. **MELAMED**. Well, our estimate is that with respect to the 1982 budget, where we know for certain, we think that is around $7 million. With respect to the 1983 budget, we think that it will be upward of that, perhaps as much as $10 million.

Senator **HAYAKAWA**. $7 to $10 million would be what percent of——

Mr. **MELAMED**. Well, depending on what numbers you are using, it is almost half or close to certainly 40 percent.

Senator **HAYAKAWA**. Well, while the implementation of the user fees would offset two-thirds of the CFTC budget, you would rather have the industry pick up half the CFTC budget and leave the public with the rest?

Mr. **Melamed**. Something like that, sir.

Senator **Hayakawa**. Since the NFA is new and untested, do you believe that the NFA should gradually take over the responsibilities from the CFTC? And if you do, assuming no implementation of user fees, who should pick up the tab for CFTC regulation during the interim period?

Mr. **Melamed**. Well, very much of it has been the responsibility of Government to carry the agency in those areas that it must exist for, and we certainly do not feel that the NFA will ever take over all the burdens of the CFTC. We just feel that we can take over a very large portion of that and the rest of it would allow the CFTC to be the oversight agency that we want it to be and that it must be, and we do not feel that its budget needs to increase for that burden. In fact, we feel that it can be decreased.

Senator **Hayakawa**. Thank you very much.

Senator **Lugar**. Thank you.

Senator Dole?

Senator **Dole**. Just one question. I assume that if Congress does move in this direction, and are fees are imposed, would they be a business expense which would be deductible for tax purposes?

Mr. **Melamed**. I do not see why not. We would assume that, sir.

Senator **Dole**. So it would even be less than we are talking about.

Senator **Lugar**. Presumably the taxpayers are making money.

Senator **Dole**. Well, that is always the problem these days. [Laughter.]

Senator **Lugar**. Mr. Melamed, we thank you for your good humor, your forceful testimony and we thank you for coming this morning.

Mr. **Melamed**. Thank you very much. It was a pleasure.

Senator **Lugar**. The Chair now calls upon a panel of Lee Berendt, vice chairman, Commodity Exchange, Inc., New York, N.Y.; Robert Wilmouth, president of the Chicago Board of Trade, Chicago, Ill.; and Clayton K. Yeutter, president of the Chicago Mercantile Exchange, Chicago, Ill.

Gentlemen, we are pleased that you are here. Let me offer this possible formula for a format of your testimony, that each one of you—and speaking in the order that I introduced you, Mr. Berendt, Mr. Wilmouth, and Mr. Yeutter—to try to confine your preliminary remarks to less than 10 minutes each and then the panel of questioners will work with you then during the balance of what I expect will be about an hour of time.

If that is agreeable to everyone, let us proceed. Mr. Berendt, if you would proceed with your testimony.

STATEMENT OF LEE H. BERENDT, EXECUTIVE VICE CHAIRMAN, COMMODITY EXCHANGE, INC.

Mr. **Berendt**. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, I am Lee H. Berendt, the executive vice chairman of the Commodity Exchange, Inc., the world's principal marketplace for futures trading in gold, silver, and copper.

We have an extensive statement which we would like to offer for the record, Mr. Chairman, with your permission, and we will confine our comments to a few brief points contained therein.

Senator LUGAR. Each of your statements will be made a part of the record in full and you may summarize them if you wish.

Mr. BERENDT. Thank you.

We appreciate the opportunity to appear before you this morning, as you begin the second review of the Commodity Futures Trading Commission and the Commodity Exchange Act. COMEX does not believe that the sunset clause in the act requires Congress to reinvent a regulatory structure for the futures industry every 4 years.

Rather, reauthorization affords Congress the opportunity to accomplish two purposes: First, to evaluate the performance of the Commission and determine whether it should be reauthorized; and, second, to fine-tune the regulation of futures markets and their participants.

Unfortunately, the process of CFTC evaluation and reauthorization this year may be buried under a number of different legislative proposals. My colleagues on this panel and I will address various features of those proposals. However, consistent with the well-understood purpose of the sunset clause and reauthorization hearings, COMEX believes that an evaluation of the Commission should be the first order of business.

In 1978, the Commission was a besieged and embattled Federal agency that suffered from a poor public image. However, COMEX believes that since that time, the Commission has demonstrated that it is an important and effective Federal agency. The Commission has satisfactorily dealt with a number of difficult issues including option trading, stock index contracts, the silver crisis, the jurisdictional dispute with the SEC, and the liaison with the Federal Reserve Board and the Treasury on financial futures contracts. This liaison has enabled the exchanges to develop financial futures markets which will ultimately result in cost efficiency for hedgers, consumers, and therefore the general public.

These comments, however, should not be construed to imply an agreement by COMEX with the CFTC's current legislative proposals—nothing could be further from the fact. However, COMEX does believe that the Commission is satisfying its statutory mandate and should be reauthorized.

In addition to evaluating the performance of an agency, reauthorization is a time for fine-tuning a statute. This is true because of the disastrous potential if extensive amendments to the act are made precipitously with little regard for the potential effects on futures markets. In that light, the futures industry has submitted its own legislative proposal entitled Recommendations for a Futures Trading Regulatory Improvement Act of 1982. With the committee's permission, Mr. Chairman, I would like to offer this document which I believe has been distributed to the committee for inclusion in the record.[1]

Senator **Lugar**. It will be so included.

Senator **Dole**. The whole document will not be reprinted in the record, will it?

Senator **Lugar**. How sizable is the document?

Senator. **Dole**. It would cost several thousand dollars.

Mr. **Berendt**. Well, we hoped that it could be reprinted but it certainly is the chairman's——

Senator **Lugar**. Well, we will let Senator Dole give us advice. The chairman will waive the document for the moment and check the technical problems before we decide whether it will all be printed. Obviously it will be a part of our proceedings.

Senator **Dole**. It would probably pay for the first year's operation of the CFTC. [Laughter.]

Mr. **Berendt**. Included in the document, Mr. Chairman, is a draft bill which if the document as a whole cannot be reprinted, we would hope that at least that——

Senator **Lugar**. That would be an excellent suggestion. Let us just waive that for a moment and determine how much to print.

Mr. **Berendt**. Thank you.

Senator **Dole**. It is double spaced.

Mr. **Berendt**. COMEX completely endorses this proposal. The proposal does not attempt to rewrite the act. Rather, it proposes modest changes to nine sections of the act and is the direct result of industry experience in living with the act. It seeks only changes which appear to be cost-justified methods of eliminating regulatory flaws.

In dramatic contrast to the industry proposal, the CFTC has presented to this committee a complex package of drastic and far-reaching amendments. The CFTC proposal covers 45 sections of the act and an exceedingly broad range of topics. The CFTC seeks not to fine-tune, but to adopt new measures which would significantly change the regulatory scheme and which would result in dramatically increased costs for the industry and the public, without any perceptible benefits.

The Commission says that its proposal is an attempt to streamline and simplify the act. However, the proposal would add almost 5,000 words to the act—a strange approach to streamlining and simplification. I have submitted to this committee a detailed statement which I mentioned earlier. We have referenced all of the sections in the Commission's proposal and explain our positions on them.

However, two aspects of the industry proposal should be of particular interest to this committee because of currently existing inhibitions on the effective functioning of contract markets. They relate to an exchange's ability to adopt rules and to create new contracts.

The CFTC review of exchange rules under section 5a(12) has been a constant source of well-recognized problems for the effective administration of contract markets.

---

[1] See p. 336 for an extract of the above-mentioned legislative proposal submitted by Mr. Berendt.

Time delays are the chief problem and can be traced to three sources. First, the CFTC can and does indefinitely delay rule approvals merely by notifying an exchange that it is unable to make a determination within the specified period. Second, the statute requires the CFTC to determine which exchange rules are of major economic significance and to publish such rules for public comment before approval. Third, although Commission approval is only required of those rules which relate to terms and conditions in futures contracts or relate to other trading requirements, the Commission expanded this to an all pervasive authority over day-to-day management decisions.

These time delays are used by the staff of the Commission as a bargaining chip to cause rule changes that are not within the scope of the act.

The industry proposal recommends three simple amendments to 5a(12) to remedy these problems: First, impose realistic, but enforceable, time limits. Second, eliminate the major economic significance determination. This would significantly reduce time delays and would not have an adverse effect as a result of the lack of public comment solicitation. Since 1978, of the many rules submitted by COMEX to the Commission, only eight have been published for comment, and according to CFTC records, only two public comments were submitted.

Third, limit CFTC review to rules which would have a significant impact on market participants. Not only would this decrease the regulatory burden, but also would focus Commission attention on matters of importance in the markets and remove the need for approval of purely administrative details.

The CFTC proposal, however, would make virtually all exchange rules reviewable, including administrative rules. This change could have a crippling effect on the ability of markets to adopt rules related to exchange administration.

The CFTC has recommended a 10-day period to notify an exchange if it intends to review any rule of the type described as all other rules. If the Commission gives such notice, then under its proposal it could within 30 days thereafter send another notice of its inability to review the rules. In other words, by sending two notices instead of one, the Commission will rid itself of all time limits for rule approval.

Finally, the CFTC's proposal fails to include two important procedural safeguards. First, an amendment, as the industry proposes, to assure that each rule disapproval will be supported by specific CFTC findings that the rule is subject to the approval process and violates specific sections of the act or the regulations.

Second, a provision granting exchanges a hearing on the record in any disapproval process. The CFTC proposal has painstakingly provided the SEC with a hearing on the record if the SEC challenges the CFTC's approval of a stock index futures contract. Why is the Commission so reluctant to accord the same procedural safeguard to members of the futures industry?

Next, let us focus on the process of contract market designation. Despite the extensiveness of the CFTC proposal, the Commission has ignored the area in which it appears that the regulatory burden on both the CFTC and exchanges could be significantly reduced. The CFTC proposes measures which threaten even further delays in a slow and economically unjustified review process.

The current statutory standard is that a proposed contract not be contrary to the public interest. This is an extremely liberal test designed to encourage new contracts. Despite this, the CFTC has misinterpreted section 5(g) by requiring a showing that the contract is in the public interest, has an economic purpose and is commercially viable. The Commission also requires economic justification of individual terms and conditions. However, as many noted economists have suggested, the marketplace, not the CFTC, should determine whether a new contract should or will trade.

COMEX believes that if any review standard is needed, the industry proposal is the correct one—whether the contract can be used to perform a hedging or risk-management function. COMEX also urges Congress to adopt a reasonable timetable for the Commission to conclude its review. COMEX supports the industry proposal of a 6-month timetable.

In conclusion, Mr. Chairman, I would like to reemphasize that the reauthorization process should not be viewed as a time to completely restructure the regulatory environment for the futures industry. This is not what was intended by the sunset clause in the act. Industry, and therefore society, have only limited funds to spend on regulation. Therefore, cost-benefit analyses become critical and regulators not only must find the least costly approach, but must issue regulations which promise to achieve the greatest benefits and avoid regulations which would have an immaterial impact.

Reauthorization should be placed in its proper perspective. This review process should reauthorize the CFTC and fine-tune the act—it should not redesign the regulatory scheme leaving the industry a shambles in its wake.

Thank you for your time. I will be glad to answer questions.

Senator Lugar. Thank you, Mr. Berendt.

We will now hear from Mr. Wilmouth.[1]

STATEMENT OF ROBERT K. WILMOUTH, PRESIDENT, CHICAGO BOARD OF TRADE, CHICAGO, ILL.

Mr. Wilmouth. Thank you, Mr. Chairman. I am Robert K. Wilmouth, president of the Chicago Board of Trade, the world's oldest, 137 years old, and the largest commodity exchange in the country. We do roughly 50 percent of the commodity business in the United States.

We had hoped that this CFTC reauthorization would be mainly a fine-tuning of the CFTC Regulatory Act. Instead, we find the CFTC seeking increased controls, increased manpower, and increased spending. We certainly would support, 100 percent, the Futures Trading Regulatory Improvements Act of 1982 which Mr. Berendt referred to. We also support the proposals that were put forward a few moments ago by Mr. Melamed for the National Futures Association which will take over may of these various areas where the CFTC is seeking more power.

---

[1] See p. 376 for the prepared statement of Mr. Wilmouth.

Let me focus, if I can, on two specific issues of importance to the commodity industry and to the Chicago Board of Trade. I do not want to beat a dead horse to death, but let me take a little bit different approach if I can for just a moment on the subject of transaction taxes and then move on to judicial review of CFTC emergency powers.

Senator **Dole**. Is that a tax or a fee?

Mr. **Wilmouth**. Well, that is just the problem. The Commission calls it a fee but in my mind it is plainly a tax, very plainly a tax. The rationale for this tax——

Senator **Dole**. That would give us in the Finance Committee Jurisdiction. [Laughter.]

If you have had any experience with the Finance Committee, you may want to call it a fee. [Laughter.]

Mr. **Wilmouth**. Well, I think the finance part of the problem is that their rationale for this tax/fee is that its regulatory services mainly benefit market users, and thus they are saying that the market users should pay for the CFTC's program.

Now, the CFTC's regulation benefits the futures market and the beneficiaries of the futures markets are really the entire public. The pricing efficiency and the risk transference mechanisms that the markets provide lead, we believe, to lower costs to producers and reduced prices for consumers.

The benefits of the futures markets are thus widely spread and the CFTC costs should be financed from general tax revenues.

A transaction tax will endanger the futures markets because of its effect upon the professional traders who provide the basic liquidity that makes these markets tick and that we must have in order to survive. Our professional traders in the two largest exchanges, the Chicago Mercantile and the Board of Trade, roughly account for 40 to 60 percent of the volume on our markets. Very clearly the brunt of this transaction tax will fall on them. These talented traders, I can assure you, will then have some difficulty in continuing to supply the high volume of transactions we feel are necessary in order to keep up the liquidity of the marketplace. If volume declines, liquidity is going to decline. If liquidity declines, then these functions which are important to so many segments of the market will suffer. Our commodity futures markets will no longer be the vital force that they have become in agriculture and now in financial instruments.

A second point that I would like to particularly emphasize is the need for judicial review of CFTC emergency actions. Everyone in Government should be held accountable for their actions. As an elected representative, you are held accountable every 6 years for yours. But CFTC Commissioners, unlike elected officials, are not accountable to any constituency. There is really only one way that the CFTC can be held accountable for its actions, and that seems to us to be through judicial review. In no other area is the CFTC accountability perhaps as important as it is in judicial review of their emergency actions.

Their powers under the emergency actions section of the act are absolutely awesome. The CFTC can order trading for liquidation only. They can suspend trading. They can and they have closed a market entirely. With a fiat-type decision, they can even abrogate private contracts. Since it is vital that they be held accountable for their emergency actions, then we think it is also vital that judicial review of such actions be obtained. In fact, it is absolutely imperative, and there are several reasons why this is so.

I think that the obvious reason is that we need judicial review to correct CFTC errors that might occur. The Commission is fallible, like all of us. It is capable of wrongly perceiving that an emergency exists. It has in the past. Judicial review is simply the only way to correct an erroneous Commission determination.

I think the other reason, if perhaps a little less obvious, is the fact that it kind of keeps an agency honest. If an agency knows that its actions are not reviewable, it is inevitable that even the best intentioned agency is going to be less rigorous, less careful and perhaps less thoughtful in taking those actions. Their awareness that a court can review its emergency actions will help to assure a high level of CFTC performance in this area.

They argue that this might disrupt the marketplace. I do not think it will. We have to remember that in any event, any emergency action that they take, any order that they do take or put in place, would remain in effect until and unless a Federal judge declares it illegal.

There are also a couple of other changes that I would like to briefly mention in the Commodity Exchange Act.

First of all, the Commission's authority to approve exchange rules would be limited under our proposals to rules of legitimate regulatory concern. Currently, the Commission interests itself and in fact inserts itself into the approval of virtually all exchange rules, even those relating to decorum on the exchange floor.

Second, the hopelessly vague public interest test for new futures contracts we feel should be replaced by a more rational hedging or risk management type test.

The Chicago Board of Trade also wants to go on record as strongly opposing the CFTC's proposal concerning controlling persons. The CFTC argues that it needs to be able to target the real wrongdoer, that while the proposal is very far-reaching on its face, and they admit this, they can be expected to exercise their considerable prosecutorial discretion in a very reasonable and fair manner. We do not believe that they have made any showing of necessity and we find such a far-reaching grant of discretion to be obviously an error.

Finally, we are concerned about the CFTC's proposed amendments to carry out this SEC/CFTC jurisdictional agreement or concordat. I am afraid these amendments would unwisely blur the line between these two very dissimilar agencies by transferring the regulation of certain risk shifting instruments from the CFTC to the SEC. I think the problem here is that the SEC cannot be a proper regulator of such instruments. Its purpose is to regulate instruments that perform a capital formation function, and the regulation of risk shifting instruments clearly belongs to the CFTC.

Let me point out one of the technical problems we see with the jurisdictional proposal. The CFTC's program for the trading of options on futures contracts is a very limited program in which each commodity exchange is allowed to trade only one option for a 3-year period.

The SEC, on the other hand, stated that it is prepared to license trading in options on physical commodities without any such limitation—two or three for an exchange, and no 3-year waiting period.

The CFTC's proposal in this jurisdictional concordat makes no attempt to correct this disparity.

Rather than allowing this committee to study this particular issue and other issues we think are inherent in this agreement, they have also done something else that bothers us greatly. They seem to be hellbent on a course intended to breathe life into this administrative agreement that they reached by some type of a fiat.

Just last week, on Monday, February 22, the CFTC published in the Federal Register a notice of a proposed rule purporting to implement this agreement by exempting transactions in options on financial commodities from the options ban enacted by Congress in 1978, provided that these transactions occur on a stock exchange.

In a transmittal letter to Chairman Helms, dated Friday, February 19, Chairman Johnson of the CFTC specifically noted that immediately after the 30-day comment period in the Federal Register, they intend to adopt this rule and to make it effective immediately. Clearly, it seems to us that the Commission now is attempting to circumvent this committee and these hearings and enact its legislative proposals administratively. This is behavior which we do not believe should be countenanced.

Mr. Chairman, we have prepared a number of other pieces of material for the record, and I ask that they be included. There is a written statement and some supporting documentary material. We have also prepared, with the help of Dr. Douglas Breeden, of Yale University and Stanford, some statistical simulation work on futures markets which I know is a subject of interest to this committee.

There has also been some discussion in Senator Roth's committee with respect to off-exchange commodity fraud transactions and we prepared some material on that, plus the letter to Senator Helms. We would like the opportunity to insert those.

Senator **LUGAR**. How much material now, as we are weighing——

Mr. **WILMOUTH**. This does not have to be inserted in the record, just for the committee members.[1]

Senator **LUGAR**. All right, that would be fine.

Mr. Yeutter.

STATEMENT OF CLAYTON K. YEUTTER, PRESIDENT, CHICAGO MERCANTILE EXCHANGE

Mr. **YEUTTER**. Mr. Chairman and Senator Dole, I have nothing additional to submit for the record, only my prepared statement. First of all, it is very nice to be back before the committee again.[2]

As you can tell, Mr. Chairman, we have divided the subject matter areas and this morning I would like to concentrate on two or three topics. First of all, some comments supplementary to those of Mr. Melamed on the user fee or user tax issue, however it is denominated. Second, a few comments on the rule review and contract approval process; and then finally a brief comment on the overall reauthorization question.

---

[1] The documents referred to by Mr. Wilmouth have been retained in the committee files.

[2] See p. 395 for the prepared statement of Mr. Yeutter.

First of all, with respect to user fees, which is probably the most difficult issue in this reauthorization process: I would like, Mr. Chairman, to subscribe to everything that Mr. Melamed said. He articulated the issues very well indeed. I would like to supplement them a bit, perhaps in a more philosophical way or with a slightly different approach.

It seems to me that there are really three questions that Congress must answer on this issue. They must basically be answered by the Committee on Agriculture, but a couple of them involve other committees as well. The three questions essentially are: First, what level of regulation is necessary and proper in this industry; second, who will provide that level of regulation; and, third, who will pay for it? In a nutshell, it is as simple as that.

Taking the issues one by one, obviously the level of regulation that is necessary is a question that has to be answered by the Congress in the first instance, in the kind of authority that it provides for the regulatory agencies involved in this process. Of course, it must also be answered by the regulatory agencies through the kind of job they do.

I want to emphasize here a point that did surface a little earlier this morning, and that is that we are talking not just about what the CFTC does but about what all the regulatory entities of this industry do. We have a tendency sometimes to say that if we need more regulation in a particular industry, then let's have the Federal Government do it and let us do something about the size or spectrum of responsibilities of that agency.

Perhaps a better answer in many of these cases is to say that an agency or entity non-Federal in nature ought to be doing more and let's make sure that they do. In this case, Mr. Chairman, we are talking about what the brokerage community will do, although that is a relatively modest segment of this picture, particularly what exchanges such as ours will do and we certainly are to be held accountable for the functions for which we are responsible, what the CFTC does or should do, and then finally, of course, the NFA, assuming it comes into being as anticipated.

That then leads into the next question. Once we decide—by "we," I mean the governmental structure of this country—what level of regulation is necessary for this growing, diverse and evermore important industry, the ensuing issue is what the proper role of these individual entities should be, that is: What the brokerage community should do, what the exchanges should do, what the CFTC should do and what the NFA should do? That too merits some discussion by this committee, and in some cases by other committees of Congress as well.

Here, of course, the NFA brings in an entirely new element of regulation that we just have not contemplated in the past. I have been a little disappointed in the hearings thus far, Mr. Chairman, in that there hasn't been much discussion by officials of the CFTC with respect to what role the NFA should properly carry out. I would like to see more focus on that and less focus on what the CFTC believes it can and should do. The policy question is what should be the respective roles of these two regulatory entities that are going to exist side by side at the national level.

Going beyond that, it seems to me that there is a philosophic question as to the role of the CFTC itself in this picture.

In our judgment, Mr. Chairman, that role should essentially be one of oversight. The basic line of regulatory responsibility ought to start with the exchanges, and then above that with the NFA. The industry itself should do the primary job of policing this industry. The primary regulatory job should not be a function of the CFTC, it should be a function of the exchanges and the NFA, and the CFTC ought to posture itself in an oversight role.

Now, if we, the exchanges, are not doing our job, and if the NFA is not doing its job, then of course the American public has no alternative but to place greater responsibility in the hands of the CFTC and provide greater funding for them to carry out an expanded regulatory role. But that should not be done until and unless it becomes apparent that the exchanges are not doing their jobs and the NFA is not doing its job.

Let us shift then, if we may, once those policy determinations are behind us and consider who should pick up the tab for this total regulatory responsibility. In this regard I would like to put some ballpark figures before the committee, if I may. There was some discussion of numbers this morning and it seems to me it might be helpful if we focus on those in a very rough way.

First of all with respect to where we stand now in terms of funding. My initial point is that we already have a user fee and a very substantial one. Mr. Melamed mentioned this in his testimony. The user fee to which we refer is the cost of regulation already being borne within the industry in a variety of ways, particularly by the compliance programs of the individual exchanges.

We tried, Mr. Chairman, to get some hard data on this subject prior to these hearings. The data are not that good yet, but I will give you a conservative number. Mr. Melamed's number was that the exchanges are providing perhaps as much as half of the total regulatory burden. The CFTC is providing now about $20 million and the exchanges themselves perhaps another $20 million.

Let us assume that it is not that much, that it is in the $10- to $15-million range. I am confident that it is far beyond $10 million, probably at least $15 million and it could be as much as $20 million, depending on how one defines regulations.

In round numbers then I would say that the industry is now providing at least a third of the cost of regulating futures trading in this country, and the CFTC is providing the remainder. So the question is: Is that right? Is the CFTC providing more than its share? Is the oversight function worth that much or are we asking too much of the taxpayer in providing $20 million out of a total burden of perhaps $30 or $35 million?

Putting it another way, the question is how much public protection or protection of the general public interest is involved versus the service and regulatory functions that are of primary benefit to the industry? That is obviously a question for the committee to discuss further during its reauthorization deliberations.

Let us just move the NFA into that picture and observe its impact between the present fiscal year, which as you know ends on

September 30, and fiscal year 1983. As you indicated, Mr. Chairman, Chairman Johnson asked for a $23 million budget for fiscal year 1983 compared with the $20 million that he has had available this year.

Now I am a little confused by his statements of the last few days as to whether he sees that $23 million as constituting the total regulatory burden at the national level, meaning that the $6 million or so of NFA funding could be used to reduce that $23 million, or whether he sees the NFA as an add-on and that he needs $23 million for the CFTC and another $6 million at the NFA level to properly regulate the industry; $23 million plus $6 million is $29 million, which would be almost a 50-percent increase over the funding for this fiscal year.

It is up to the Congress to determine, in the appropriations process, what that number should be.

But I would like to suggest, Mr. Chairman, that even if we went to the middle and said the burden for next year ought to be, say, $26 million, $3 million more than what the chairman is recommending, one could put in $6 million of NFA funds and hold the taxpayer contribution to $20 million, exactly where it is now, with no increase in the CFTC budget in fiscal year 1983.

As Mr. Melamed pointed out, if the NFA does its job well in fiscal year 1983, and I agree with him that it ought to be able to do a better job than the CFTC in service functions that are of primary benefit to market participants, we really ought to be able to save more than that, maybe even substantially more than that, out of the CFTC budget and the overall level of financial contribution by the taxpayer could drop still more.

Assuming the worst case situation, Mr. Chairman, it seems to me that with the establishment and implementation of the NFA, the industry will in fiscal year 1983 be moving its share of the regulatory burden from somewhere around a third this year to about a half in fiscal year 1983. In my judgment, that is a rather substantial increase.

Mr. Chairman, in my judgment, the industry will be bending over backward to carry its fair share of the load if it moves from about a third now to about half in fiscal year 1983. If that is not enough, if we are still charging too much to the taxpayer and too little to the industry in the judgment of this committee and the judgment of the Appropriations Committee, then it seems to me the answer is not to establish a user fee for the CFTC to pick up the difference but to ask the NFA to assume more responsibilities.

If one-half, Mr. Chairman, is an insubstantial level of regulatory burden on the part of the industry, then let us raise it, but let us raise it through assigning additional regulatory responsibilities and functions to the NFA and asking them to carry them out and carry them out well.

That is enough on the user fee issue. Permit me then to switch very briefly to the rule review and contract approval process. I wanted to mention contract approval, Senator Dole, because in the Senate Finance Committee you have gone through the issue of putting time limits on executive branch action on trade issues.

As you know, a few years ago we had no time limits on the executive branch and when complaints were made in the trade area, nothing happened. Finally, the dairy industry sued to force action by the executive branch and this stimulated legislation on the part of Congress in the Trade Act of 1974—to put time limits on decisionmaking by the executive branch on many trade issues.

In my judgment, there is sound reason for doing precisely the same thing here. Chairman Johnson has objected, Mr. Chairman, as you know, to the imposition of a required timeframe on the actions of the CFTC, particularly in terms of contract approvals. I do not believe that objection is justified.

I realize that it has not been a necessary objection during his tenure because, as you know, Mr. Chairman, Phil Johnson has done a superb job in moving new contracts through the approval process over the last year. I fully expect him to do so during the remainder of his tenure. I am just not sure about the next chairman of the CFTC who succeeds him, and I would be a whole lot more comfortable, irrespective of who is the chairman, if we had limits on the time that is given that agency for the approval of new contracts.

I mention rule review, Mr. Chairman, because I feel very strongly, from having spent a lot of time in this Government, that the proposal submitted by the CFTC is an improper one that simply will not do the job. The Chairman means well. There is no question but that the CFTC is now dedicated to improving the rule review process. That process has been troublesome for all of us over the last few years, when it has taken months to obtain CFTC approval of innocuous rules with little or no public protection or public interest involved.

The Chairman in essence has said the CFTC will now do it in 10 days, but if it cannot do so it wishes to preserve the prerogative of sending us a letter saying that 10 day approval is impossible.

My concern, Mr. Chairman, and I believe it is a legitimate concern, is that we will simply get dozens and dozens of letters saying that the CFTC cannot approve the rules in 10 days.

The industry proposal, in contrast to that, simply says we will give you 60 days but get the job done in 60 days. I see no reason why that cannot be achieved. I would much rather provide 60 days or 90 days or whatever is necessary but say to the CFTC let's get the rules approved, than to give them 10 days and then routinely have letters that would extend the time.

Finally, just a 30-second comment on the overall issue: As Mr. Berendt indicated, we have an industrywide proposal encompassing recommendations that we believe merit the committee's consideration. It is much less extensive than that of the CFTC, even though it looks formidable as it is deposited here. We believe that we have significantly narrowed the issues. We could include 200 or 2,000 issues in this process, but you already have many high-priority issues before this committee and the Congress in 1982. We have tried to narrow reauthorization to about half a dozen major issues. We wish the CFTC had done that. As my colleagues have indicated, they did not choose to do so. I find that regrettable. I hope that somehow we can concentrate on the major issues and not get bogged down on a lot of matters that do not merit your attention this year.

Senator LUGAR. Thank you very much, Mr. Yeutter.

Senator **Dole**. I am supposed to go back to a grain subcommittee hearing, which is also important to agriculture. We are talking about subsidies to the European community.

I think it would be helpful, Mr. Yeutter, if you could furnish us more detailed information on this $10 million or one-third, so that we would know how it is being spent. I know it may be difficult to document that, but it would be helpful so we could make a judgment.

Second, I agree that we ought, whether the Commission likes it or not, to put in some time limits because the bureaucracy, just by the nature of the bureaucracy, not with any intent, tends to move rather slowly. And I think we are all in agreement that Chairman Johnson is doing a good job. I want to leave that inference in the record. Would that be a fair statement?

Mr. **Yeutter**. We would certainly agree.

Senator **Dole**. Everybody indicated that. And I also believe that maybe we should not rewrite, or reinvent the wheel when we have the sunset. This is a new Commission and I think it is important, at least for the first shot, that we spend whatever time may be necessary, even though the budget is small by comparison to others in the Government, it affects a lot of people. Somehow we need some educational program.

As you all know, farmers still look upon exchanges with mixed views, some do not like them at all and some think they ought to be abolished. Those are the mixed views. [Laughter.]

So there is that educational problem not only with those who use it but those who do not use it and criticize it, plus probably some of those in Congress do not fully appreciate what is done.

So I want to commend the Chairman who is spending hours and hours on this issue, because it is that important. It is important to agriculture, it is important to your industry, it is important to those who speculate properly and make investments, and so it is a matter of high priority in this subcommittee and the full committee.

It seems to me there ought to be some way we can accommodate the concerns expressed by the panel and also the CFTC. We certainly do not want the CFTC to grow just because it is there. We see efforts in the Consumer Product Safety Commission to reduce its authority. In the Federal Trade Commission, I think you have seen a major restructuring under the chairmanship of Mr. Miller, and hopefully Chairman Johnson will also make determinations that will reduce the role where it can be properly done, whether it is NFA or whatever may be added to NFA.

I also agree that the CFTC should expand its remarks on how it sees the role of NFA and where they see duplication or where they believe they can reach some accommodation, because if it can reduce the cost by reducing duplication, then that is in the interest of government, the taxpayer and the industry and those who use the exchanges. So I want to make that comment before going back to the subcommittee.

Thank you.

Senator **Lugar**. Thank you very much, Senator Dole.

Senator **Dole**. If you do agree it is a tax, we will be glad to have a hearing. [Laughter.]

Senator **Lugar**. I think that is still up in the air at this moment, which way we want to go on that.

I would like to make a comment in behalf of Senator Hayakawa. He apologizes for his inability to hear each of you and he appreciated his conversations with you in the past. They have been most helpful to him. He has proceeded to the Foreign Relations Committee which is his responsibility. We have been joined so happily in his absence by Senator Boren who has just come into this panel.

I will ask some questions to begin with, while Senator Boren is reading and then defer to him for his questions.

The legislation that Mr. Berendt mentioned and each of you, as a matter of fact, pointed out that the industry favors, after careful review of the issues, does appear to be less extensive in the number of issues raised than the CFTC bill which we discussed at our last hearing. I am curious because of the fact that Mr. Johnson, who advocated fairly strongly, as the record will indicate that the Chair engaged in a dialog almost for 3 hours, ad seriatim through the sections. He tended to feel fairly strongly that in terms of the credibility of the Commission and its work that these changes as he was advocating were required. Obviously, the advocacy, I would gather, of each of you gentlemen, that the strength of the CFTC is reauthorization, its credibility with the public is important, too.

What comment can you make or do you wish to make as to why you believe that the CFTC at this point has moved to tackle so many issues, and is it your judgment that this is simply a labor that should not have been undertaken, or is there some possibility that Mr. Johnson taking a look at the industry, from his experience with some of you in that industry and now his experience with the CFTC, is advocating some things which he believes are fairly important for the general future of this industry and the country?

Mr. **Berendt**. Well, I think our perception clearly is different from that of Chairman Johnson. As Senator Dole mentioned, we would not want to imply anything negative about the Chairman in terms of his ability or the things he has done with the Commission, but we, as an industry, do see it differently at this point than he does.

We are of the view that there are things that need to be changed in the act and there are a set of issues which we prioritized and included in our document. If we had an opportunity to ask for a wish list, we could have included an awful lot more on it. But it was generally felt that after living with the act as we have for the past several years, operating under it, going through the day-to-day activities of running a marketplace, we believe that the issues raised in our document are the ones that really do need to be addressed and that the problems addressed in the additional issues in the Chairman's document really are not areas that are as significant as he feels they are or as difficult to operate under.

We are also interested in reducing as best we can the amount of activities that the Commission needs to be involved in and allowing the industry to do its work as best it can. The things that we are proposing we believe, in a sense, would streamline the Commission's work and enable us to do our job more effectively and more efficiently.

Mr. **Wilmouth**. Let me respond, if I can, to that, Mr. Chairman. The legislative proposals put forward by the CFTC are going to markedly expand their regulatory powers over exchanges and over commodity firms. We think that is unnecessary. We do not think they can justify that. Let touch upon a few areas, if I can, and give you the tone of what they are attempting to do.

They want to establish speculative position limits by informal rulemaking. Right now when they want to do something about challenging the speculative position limits that have been set by an exchange, they have to hold a hearing. They must have substantial evidence on the record, a requirement that has existed and worked well since I believe 1936. They are saying informal rulemaking will make it easier. We do not think that is the correct and proper way to go.

Under contract rules, they really want to be able to say under the guise of making it easier, look, give us 10 days and we will probably approve most anything. But hidden beyond that is the fact that if we do not want to do it in 10 days we will give you a letter, and then we will do it in 60, 90, 120, 180, 1 year or 2 years. All we are really saying is put a time limit on their review.

We do recognize and we give due credit to the Chairman for having done an extraordinarily courageous job in terms of pushing contracts through when they should be, but he is not going to be around forever. We want to make certain that we get something built into the law which gets it done. They are trying to make their task a little bit easier.

With respect to controlling personal liability, they want to be able to go after anyone anywhere along the line in the chain of authority when any person commits some type of commodity fraud. I guess if you carry it to the extreme, the chairman of the board of Shearson-American Express can be liable for the actions of somebody totally unrelated to the company but who has been designated as an agent for them to do some commodity business. We think that is improper. We think that the aiding and abetting authority that they have now is sufficient.

There is also a degree of difference between the CFTC and us with respect to what else has to be done. In addition, as Dr. Yeutter pointed out, to the millions and millions of dollars that we spend at the Board of Trade for self-regulation, we are going to contribute sums to the NFA with the combination of what we do in our self-regulatory efforts, and the addition of a massive new effort with the National Futures Association this is not the time for them to increase manpower, increase their spending, increase their regulatory control.

We had originally hoped that this would be a fine-tuning episode and that is what we are attempting to do with the proposals we are putting forward, not to drastically rewrite the act.

Mr. **Yeutter**. If I may just expand on that slightly, Mr. Chairman, it seems to me that the tone of the CFTC proposal, as Mr. Wilmouth states it, is one implying that the exchanges will not continue to do more in the way of self-regulation and will not continue to do it better than they have in the past, and I do not accept that premise. We are doing infinitely more than we were doing 4 years ago when this sunset hearing was held.

I believe the numbers will show a financial commitment in the regulatory area by the exchanges of perhaps four times what was involved 4 years ago. If we continue to increase our own self-regulatory efforts over the next 4 years, as I am sure we will, then the question that must now be asked by the Congress is why is it necessary to have this additional regulatory authority, responsibility and effort on the part of the CFTC. Why is the CFTC not providing some recognition of what the exchanges are doing and will do and what the NFA will do?

The rationale of the CFTC position is difficult to fathom. Taking the individual issues very quickly, the one on speculative position limits is very sensitive and delicate because of the silver situation of a year ago. I can, therefore, understand why the CFTC wants to make changes in the spec position limits area. But this does not mean that we should swing the pendulum all the way to the other side and overregulate because if we do we are going to infringe upon liquidity in the markets, and thereby do the entire market process a disservice. Let us do it right and travel in the middle of the road, not shift from one side all the way to the other from a regulatory standpoint.

If the Ag Committee staff will study the provisions proposed by the CFTC very carefully, they will see that in the spec position limits area CFTC regulatory authority is vastly expanded in a way that we consider completely inappropriate.

Mr. Wilmouth has raised the question of judicial review, of emergency actions by the CFTC. I find it difficult to fathom why it is that the CFTC would not wish to subject its actions in that arena to post-action judicial review. The industry proposal is not in any way intended to preclude the CFTC from taking emergency action. All it is saying that the courts ought to have the prerogative of reviewing such action subsequent thereto. That seems eminently reasonable.

Regarding the rule review process that I alluded to earlier, as Mr. Wilmouth indicated, we are concerned about that process because in our judgment the 10-day review looks good on paper and is magnificent in theory but is not going to work in practice.

One additional point that I did not mention earlier, Mr. Chairman, is that the way the rule review provision is now written, many, many more rules that are not now reviewed by the CFTC will become reviewable in the future. There will be the opportunity to do far more reviewing than presently prevails, and in my opinion that too is inappropriate. We do not need to have people sitting in Federal offices reviewing rules that have absolutely nothing whatsoever to do with public protection. Those kinds of rule changes ought to be handled on an instantaneous basis, not after nitpicking for a 6-month period of time, which is what has often occurred in recent years.

Finally, on the control issue, Mr. Johnson's comment about our criticism on that issue has been, there really is no problem, because the CFTC will never interpret that language the way the industry fears it may be interpreted.

Well, my concern on behalf of our brokerage community brethen that I am not so sure that if I were sitting as the chief executive officer of a brokerage house I would want to rely on the good will of any chairman, as estimable as Mr. Johnson is, that the CFTC interpertation will always be responsible. It just seems to me that is not good legislative policy.

Senator **Lugar**. Well, let me say, and I think you will appreciate the fact that we come to these collections of issues once every 4 years. I think Mr. Berendt mentioned that this is regrettable in a sense, that you have such a concentration of things, reinvention of the wheel and all, but nevertheless this is the way the Congress works and this is the time in which all of these things are now before us.

As I hear the industry's testimony today and we will hear another panel shortly, and we have heard Mr. Johnson and his fellow Commissioners as well as himself, there do indeed appear to be a number of issues with fairly sharp differences of opinion and which this subcommittee and then the full Ag Committee and the Senate and the House and so forth apparently are going to have to make some judgments.

Now, to the extent that some of the parties are able to narrow some of these issues, it would be easier I suppose to a more arbitrary marking of ballots back and forth on these affairs, and I hope that we will have some discussions, and there is time for that to occur. Obviously, we are sort of getting the opening arguments in at this stage, but I am hopeful that the staff at least of this subcommittee is already drawing up the score sheet of where everybody stands so that the ordinary member will have some idea of where we all are.

I am delighted Senator Boren is here as the ranking member of this subcommittee so that he and I share the usual responsibility I suppose of sifting through the whole thing at some stage to see where we are.

Let me just ask one more question before I defer to Senator Boren. In the judicial review argument—and there may be all sorts of things the Commission would do that you would want to see reviewed—if I remember Mr. Johnson's testimony, he suggested that there are times of emergency—and these you have admitted, Mr. Yeutter—in which—for example, we went through the embargo following the Afghanistan invasion in which the President of the United States felt that we ought to have that, and the exchanges were left with some difficult problems, and the Commission likewise.

Now, essentially the Commission decided—maybe the exchanges did, too—that all the decisionmaking is not clear, it needs some reading of history as to who did what, but at least for 2 days there were no markets. Now, by and large most people in retrospect think that probably is about right, although not everyone would ever agree to closing the markets, just do not stop for any reason. But is your contention that that activity ought to be reviewed sort of post-action, or subject to review, and if so for what reasons? That may be an extreme condition, but it comes to mind as one that the public would find and recognize.

Mr. **Wilmouth**. Let me answer that because the Board of Trade has been involved in two emergency actions taken by the Commodity Futures Trading Commission. Let me review momentarily each of them, if I can, and the impact that it had.

The first one was in March 1979 with respect to the so-called March wheat situation. On a Thursday evening, late, the CFTC called and indicated that they were going to suspend trading on Friday and on the following 2½ days, which were the days left to trade the contract, they would have that contract trade only for liquidation. Their rationale was the fact that they felt there was an attempted squeeze in the marketplace.

The Board of Trade stayed closed in the wheat market on Friday. We went into court Sunday, at approximately 2 o'clock in the afternoon, to fight the order. At that time we presented a case before the Seventh Federal District Court of Judge Grady, I believe it was, and indicated to him that there was no emergency. We proved our case because at the conclusion of the hearing, at about 6:30 at night, he said it was obvious that there was no emergency, the CFTC should not have shut you down, open up again on Monday morning normally. We did and the contract went off very normally. I think wheat was priced no more than a quarter to maybe three-quarters of 1 cent higher than it had been in the previous 3 weeks. It was obvious there was no emergency.

Now, that is a typical case where we believe very strongly the CFTC was in error. They committed an error that should not have been allowed to go on. Without judicial review, there is nothing that we could have done about it, and judicial review at that time authorized us to go on trading. Admittedly, when it got to the court of appeals, the court of appeals said it is nonjudicially reviewable.

Senator LUGAR. Now, is your contention that the new draft would have denied that process?

Mr. WILMOUTH. No, the new draft does not address judicial review. All the CFTC has to do now is pick up the phone, call me as president of the exchange and say, "Wilmouth, shut the place down," and I do not say why, I just shut the place down. That is a little exaggeration, but basically that is it.

Now, the other time that emergency action was applied was on January 7 and 8, I believe, during the grain embargo. That was done late Friday afternoon when the President declared an embargo on grain shipments to Russia and we were notified about it late that evening. We met in emergency session on Sunday evening, having heard from the CFTC that in consultation with the Department of Agriculture they were going to close down the grain markets for 2 days at least, and then that decision would be subject to review at a later time.

Their rationale was: We need time for the marketplace to absorb what is going on, figure out what is happening so readers can react to this change in procedure, namely an embargo on grains to Russia.

We met Sunday night to discuss it and quite frankly we felt they were wrong, totally wrong. We felt that the markets had absorbed far greater shocks, the bombing of Pearl Harbor and things like that, and they had no visible impact that the marketplace could not take care of. That is what the marketplace is there for, to take care of situations like that, to reflect supply and demand conditions, and we felt the marketplace could have very adequately done it.

However, we did feel that this was a national emergency-type thing and so we did not do anything about it. We did not seek judicial review in that particular case, and I am not saying that in every case we would seek judicial review. It may be very well that emergency powers should be exercised by the CFTC at some time or other, but to me it is plain downright un-American not to review the action of an independent government agency through the judicial process which is inherent in the democracy of this country as far as I am concerned.

Senator **Lugar**. Well, I appreciate that statement, and this offers an excellent counterweight to the other one that we have heard. I suppose that, without arguing or debating the issue, that the thought is that these markets are extremely sensitive, that even the possibility of judicial review, the upsetting the order or uncertainty of whether the markets are open or not injects new elements into the trading which are not economic, and that the degree of certainty required by a Commission order is worth something.

On the other hand, the point that you make with regard to judicial review is well taken. I am eager to see how these conflicting rights of all the parties are balanced in some way.

Mr. **Wilmouth**. Mr. Chairman, let me make just one more comment, if I can, that is apropos because of a situation that occurred this morning. Our marketplaces live with conditions that exist every single solitary day. This morning, at 6 a.m., there was a power shortage in the entire block which houses the Chicago Board of Trade. Up until about 9 o'clock or so this morning, we did not know whether we were going to open or not. The telephones——

Senator **Lugar**. Is it on at this point?

Mr. **Wilmouth**. It is on and it is operating now, and everything is fine. But my point is that the world reacts to those crises. We had calls from all over the world asking, "Are you going to open, we hear there is a power shortage. It went out over the news tickers." But that is what our marketplace is for, to handle events such as that, and so even if there could be a judicial overturn of an emergency action of the CFTC, the marketplace can absorb something like that.

Mr. **Yeutter**. The only thing I would add to that, Mr. Chairman, is that certainty is not worth the price of being wrong and it seems to me that we ought to accept some uncertainty in our lives in order to right wrongs if that be necessary. And it is not that the burden of proof is that great on the agency. Obviously, the standard to which the CFTC would be subjected in this kind of case would be one of reasonableness, and judicial overturn would be only on the basis of arbitrary or capricious decisionmaking. And, as Mr. Stassen just pointed out, the order of the Commission, the emergency order, would remain in effect until such time as it was overturned by a judge. Obviously, if the CFTC action were challenged, there would be some uncertainty as to whether it would or would not be overturned, but I would like to pay that price as a citizen to make sure that our Federal regulatory agencies are operating properly.

Senator **Lugar**. Senator Boren?

Senator **Boren**. Thank you, Mr. Chairman. Just following on on that point, would the court have the right to issue a temporary injunction pending a decision? I guess that would be the only question as to whether or not that could cause a delay in the CFTC being able to act. Or would it be a post-action, would the court have to reach a decision in order to act?

Mr. **Wilmouth**. Let me ask John Stassen, of the firm of Kirkland & Ellis, who is our general counsel for the Board of Trade.

Mr. **Stassen**. The court would have to hold an evidentiary hearing and that is what happened in the one instance where a review was taken. It was a full-fledged preliminary injunction hearing.

Senator **Boren**. They would have to have?

Mr. **Stassen**. That is correct, the judge could enter an order like that ex parte.

Senator **Boren**. They could not enter an order saying, all right, we put it on hold and——

Mr. **Stassen**. No, under standards of equity jurisprudence they would have to have the party coming forward and convince them that the Government was wrong——

Senator **Boren**. Right.

Mr. **Stassen** [continuing]. And the Government would have a chance to respond.

Senator **Boren**. So that would answer the argument that the judicial review might cause a delay in implementing of any kind of emergency action?

Mr. **Berendt**. I am glad that you are on that point, because I think it is important to keep in mind that we are not suggesting that the Commission should not be permitted to take an emergency action. What we do believe, though, is that the process is better if the ability to review the action is there. The exchanges operate under that basis and it in fact does enhance the deliberative process. When you know there are people that are going to have the opportunity to review the actions you take, you take in many cases that little extra moment of thought before you do whatever you believe needs to be done, and we think that the process would be better with the review in there, rather than worse.

Mr. **Yeutter**. Putting it in a nutshell, Senator Boren, our position is that the Commission should be held retrospectively accountable for what it does.

Senator **Boren**. Yes.

Mr. **Wilmouth**. Senator Boren, I have been trying to find out but I do not know of any other case where the powers are as enormous as those of the CFTC to close down a market and abrogate private contracts and——

Senator **Boren**. That would not be subject to review.

Mr. **Wilmouth**. Yes, that is not subject to review.

Senator **Boren**. Have the exchanges ever shut themselves down? Can you think of a situation where there was an emergency?

Mr. **Wilmouth**. The Board of Trade has in certain cases ordered liquidation of certain contracts. Whenever we perceive an emergency ourselves, we will take action. That is the whole focus of our self-regulatory program. We have a business conduct committee, a floor governors committee, a paid staff of over 43 people solely involved in regulating the exchange in that area.

Senator **Boren**. Now, what would the NFA, what will be their expanded role here in terms of self-regulation? I would like to go back to the point where you might see the possibility of some duplication and overlap in additional powers that the CFTC is seeking and additional budgets compared with what the NFA would be doing. I apologize if this has already been talked about, but what are the most essential areas where you see the duplication?

Mr. YEUTTER. Senator Boren, the NFA in its own testimony has articulated the various areas of responsibility which it will undertake, so I will not delve into those with specificity now. But suffice it to say that they are prepared to take up a number of what I would call service functions for the industry. These are areas in which one could argue, at least, that the benefits to the industry are greater than the benefits to the general public. That is the rationale of having the industry pick up the whole tab, even though there are some public benefits involved. Included would be registration functions, for example, a major element of the regulatory process.

And one could add arbitration which, as Mr. Melamed indicated earlier, takes 3 or 4 years now in a CFTC reparations procedure. Hopefully when some of that responsibility is shifted to the NFA, maybe we can do it in 1 year through an arbitration process that should be more efficient.

Aside from the service functions, the area that has a major regulatory impact and which is very troublesome, as evidenced by the recent Roth hearings and the GAO report, is the area of enforcement in nonexchange transactions. There are a lot of nonusers of the exchanges who have caused tremendous difficulties in this industry and an image problem for all of us because the CFTC simply does not have the financial resources to properly enforce misconduct in that arena. That is why Chairman Johnson has suggested additional authority for State law enforcement bodies, and that is why we feel the NFA should step in in a very aggressive way. We believe the NFA will have financial resources over and above what the CFTC will have, and this so-called nonmember FCM regulatory enforcement program is one in which it can be very helpful.

Senator BOREN. So I gather you are in agreement at least to an extent with the GAO report saying that the CFTC does not have adequate financial resources for follow-up and enforcement of it?

Mr. YEUTTER. Yes, I would agree with that, Senator Boren. That is an oversimplified answer because obviously one would need to appraise all of the issues in that report, and one must also recognize that it is a report done 3 years or so ago, and a lot of improvement has occurred at the CFTC since that time. Chairman Johnson articulated that in his testimony. We would all agree that the CFTC is performing in a much more adequate fashion today in all areas than it was 3 or 4 years ago, including this one. But at the same time, in the so-called nonmember FCM problem, there is no question in my mind that we need much more effective regulation by someone.

Senator BOREN. And you think the NFA would have an increased role there?

Mr. YEUTTER. Very, very much so and very properly so.

Senator BOREN. What will be the financial resources in terms of if we could draw some comparison—I noticed that Congressman English last week in the House hearings suggested a deferral of the user fees while we evaluate the expense that will be involved and the activities that the NFA would be undertaking. Do you have any kind of an estimate as to what the NFA will be undertaking budget wise in comparison with what the proposed user fees from NFA members would raise?

Mr. **Wilmouth**. Leo Melamed testified earlier this morning, Senator Boren, with respect to the NFA, and essentially, if I can oversimplify what he said, he is talking about the NFA costing between $8 and $10 million a year. That amount is coming from the exchanges, the futures commission merchants, the commodity pool operators, the commodity trading advisers, et cetera. The funding base, as he pointed out, is the same as the CFTC is seeking in its user fee/tax.

Senator **Boren**. About equal?

Mr. **Wilmouth**. The base is about equal, but we would raise less money than would be raised by the CFTC user fee. Congressman English has a proposal all of us at this table, and I believe the industry would support. We have undertaken this huge effort to establish the NFA at great cost to ourselves, supplementing our own internal self-regulatory ability. We would like the opportunity for several years, at least 2 years, to try the NFA, to come back and to prove to this committee and to anyone else that the NFA does work. We believe it will have done a better regulatory job and will have taken over some CFTC functions. It will eliminate redundancy and duplication of efforts somewhere along the line. That is very important to us.

Our main point, of course, is that the CFTC seems to be attacking this from the wrong premise. If my figures are correct—and they came to me from one of the Commissioners—about 25 percent of the budget of the CFTC now goes toward regulating off-exhcange activities, and yet they want to charge us this user fee in order to get more money to handle that particular area. That burden should not be placed on us. That is a general public burden and it should come from general tax revenue. That is our point. We will take on our share and our fair share.

Senator **Boren**. So you would be very favorable toward the English proposal?

Mr. **Wilmouth**. I think all of us would tell you the industry would support the English proposal. Give us a couple of years to see what we can do.

Mr. **Berendt**. Yes, I would agree wholeheartedly with what Mr. Wilmouth said. But I think it is important in addition to that to keep in mind that the industry is to a great extent already assuming its regulatory responsibility and underwriting the cost of much of it and will do so to a much greater extent with the NFA. We do that through the exchanges themselves. The members are assuming a tremendous increased cost as a result of the regulation that we now have to live with.

As an example, we took a look back to 1976 and in November of that year, when our fiscal year closed, we found that we were spending a little under $600,000 annually on enforcement and compliance; and the year just ended, in November 1981, we were spending approximately $3 million at the exchange for that function alone, at COMEX, just for compliance, enforcement and what have you, dealing with the CFTC and regulating our markets. The other exchanges have found similar increases. We have numbers that indicate that in terms of percentage some have increased even to a greater extent than we at COMEX.

So the members are underwriting that cost as a day-to-day activity. With the NFA, we think that we will be able to shift an awful lot of the burden from the CFTC on to the industry and on to the exchanges as we have always asked for the burden. I do not think in any way that the conversations about user fees and our concern or objection to them should be viewed with an eye that the industry is not interested in regulating itself or in doing what is required to maintain adequate liquid, effective markets. It is just the opposite.

We have worked very hard in the industry, many members in the industry have worked very hard, Leo Melamed being one of them, to develop an NFA. Unfortunately, just when it gets to the point of being a reality and beginning to be able to take on an effective position for the industry, we are faced with a setback and we are very concerned about that. I just feel that it is very important that you gentlemen not in any way view our displeasure with the fee as a way to avoid regulation.

Mr. YEUTTER. Just one supplementary comment on that, to articulate some of the concerns within the industry on the user fee issue. One example is a quote attributed to a staff member of the Senate Ag Committee to the effect that there is going to be a user fee on this industry because those guys can afford to pay and therefore they ought to pay. I did not realize that was the way we established tax policy in this country. It seems to me that there ought to be a more rational basis for doing so.

The industry is willing to pay its fair share, Senator Boren. It simply does not want to pay way more than its fair share and in essence be forced into subsidizing the American taxpayer in terms of also paying the share of regulation that should properly be attributable to the taxpayer, that is, the share that involves public protection and the general public interest.

If we can establish a system that will properly apportion a fair share, that is all we ask. Congressman English was articulating that very concept. If we say, no, we cannot get enough out of the industry and the NFA, one must have a user fee for the CFTC as well, then it seems to me that we have: No. 1, the worst of all worlds in terms of tax policy; and No. 2, what we deem to be an entirely unjustified and unfair position with respect to the industry. We do not believe that an additional user fee just to support the CFTC is appropriate, necessary nor justified.

Senator BOREN. Mr. Chairman, have you already gone over questions about the silver episode or any actions——

Senator LUGAR. We have not talked about that specifically today.

Senator BOREN. But that, of course, is going to be a matter of interest, so I think that the hearings ought to reflect the questions about it and I just wonder what does the industry feel it has learned itself as a result of that episode and the actions that have been taken in the aftermath of that?

Mr. WILMOUTH. Well, there were two exchanges involved in the so-called——

Senator **Boren**. I do not want to disappoint you in not asking that question. [Laughter.]

Mr. **Wilmouth**. I think this is the fifth congressional hearing in which this subject has come up, and maybe that is the point to start with, Senator, because I think it is important.

This subject has been hashed and rehashed in a number of congressional committees, in the press, up one side and down the other. And speaking for the Chicago Board of Trade, I think that every single solitary effort that we undertook was done the right way. When we increased margins 22 times, we did the right thing. When we set speculative position limits, we did the right thing. When we excluded the chairman of the board of the Chicago Board of Trade from every single solitary one of our deliberations regarding the silver episode, I think we did the right thing. When we polled every single member of our board of directors when we took specific action as to what position they had in silver, I think we did the right thing.

My point is that with all the congressional hearings and all of the press and media publicity that has been attended upon the silver episode, I think what we learned in a nutshell is that we did the right thing. The system worked.

Senator **Boren**. So you are saying in essence that there is no need for legislative hearings, that the self-regulatory system worked?

Mr. **Berendt**. Absolutely. To follow up on what Bob had to say, I think the results showed that the self-regulatory system that we have talked so much about did in fact work. It might not have worked exactly the way a lot of people felt that it should. There are a lot of differing opinions about what the exchanges should have done and when they should have done whatever they did, but basically the system did work.

One of the nicest parts about what we are seeing right now is that in the aftermath of the silver episode, everyone was saying how the silver market had been basically destroyed and it would never be a vital part of the markets again. In fact, that has been proven not to be so. The markets are trading. On COMEX in particular, the silver market is showing new life and new interest. It is an active and viable marketplace and continues to be.

One of the things I think it is most important to learn from that is that the people that are closest to the market—even though many of them are now being very closely scrutinized for the activities that they were a part of during that period—the people that are closest to the market are the people that really do understand best how to regulate it. They understand the issues, they understand how delicate a mechanism these markets are, and I think that those are some of the lessons that we have learned.

Just one other point on what is constantly referred to as the margin issue as it relates to what happened in silver and in other markets. Chairman Johnson has indicated that the Commission just would not be equipped to deal with margin adjustments and to make changes as often as we had to during the silver episode.

So I think there are a lot of points that we have all benefited from——

Senator **Boren**. In terms of evaluating the margin requirements in the different markets, do you—what impact does the situation in the general economy have? I would think that—now, for example, we are in a period of, without exaggerating, great uncertainty in terms of where the economy is headed. Does this impact—do you evaluate this in terms of dealing with margin requirements? What kinds of things do you look for in particular markets that might be flares to you that margin requirements might need to be changed?

Mr. **Yeutter**. Well, we certainly do look to those kinds of issues, Senator Boren, because, as we recognize, margins are really performance bonds. That seems to be a differentiation from margins in the securities area that a lot of people have difficulty discerning, including—at least some staff at the Federal Reserve. But the function is different and that is why the margin is different, and obviously what we look at is all issues that have some bearing on the potential ability of the market participant to pay, for example, the capacity to carry out his contractual obligations and the probability of default. That is really what is involved in a performance bond, and obviously conditions that exist in the economy are a part of that overall picture.

The function of our committee that deals with the margin issue is to look at everything that may have some impact on the performance bond question and to do it promptly. I simply do not believe there is any Federal agency that can do that kind of job effectively.

Mr. **Wilmouth**. Senator, I have submitted for the record earlier this morning a statistical simulation study done on margins by Prof. Doug Breeden, of Yale and Stanford University, and I think it will go a long way toward answering those questions.

Let me cite three other very practical things, if I can. No. 1, we think it is extremely important that margins be set by the participants in the marketplace, those who know and understand the marketplace. They can react very quickly. We can have an 11 o'clock in the morning margin meeting and change margins at the opening of grain at 9:30 the next morning

No. 2, there is kind of a built-in safety factor in most margins. I think most of us set our margins in relation to 1 day's limit price move. Therefore if there is any problem we can liquidate the contract and probably not suffer any loss. So there is that built-in mechanism or factor that I think is important to bear in mind.

Mr. **Berendt**. I cannot add too much to what my colleagues have said, except for the fact that market volatility is one of the most important things that we do look at when we are setting margins, and we are sensitive to a lot of the issues that you alluded to, but we are really most concerned with the ability of people to carry out their obligations.

Senator **Boren**. Right.

Mr. **Yeutter**. One point I should add to that, Senator Boren, is that margins should not be set at a much higher level than necessary because that will simply increase the cost of trading. We have people in Federal agencies that say, "why do you not set them at 30 percent, the way they are set on securities," even though that is an apples and oranges comparison.

Well, the answer to that is that if you do not need anything near 30 percent in terms of the performance bond function, then why put that additional cost in the trading process which simply impedes the effectiveness of the risk management function. That simply does not make any sense.

Senator Boren. Probably the biggest factor is extreme volatility because then you would not be able to recover from the failure of 1 day.

Mr. Yeutter. Yes.

Senator Boren. Thank you very much, Mr. Chairman. I have asked to insert in the record a letter from State Senator Robert Miller, of the State of Oklahoma, who asks that his letter and comments be included.

Senator Lugar. Without objection, it will be made a part of the record.

[The letter from Oklahoma State Senator Robert Miller to Senator Boren follows:]

Oklahoma State Senate,
Oklahoma City, Okla., February 24, 1982.

Hon. David Boren,
U.S. Senate,
Russell Office Building, Washington, D.C.

Dear Senator Boren: We respectfully make this statement to you and your colleagues on the Agriculture Subcommittee in regard to the futures on live cattle and its effect on the ranching industry.

It was first thought that placing live cattle on the commodity futures market would have a stabilizing effect on the overall industry but after about eighteen years, it has proven to have the very opposite effect. In fact, for the past eight years it has completely devastated the cow-calf business.

As an example, in our personal operation we have had only one profitable year since late 1973. Our operation in 1973 had less than one hundred dollars per cow indebtedness. This has increased steadily since then with the exception of one year. Presently the indebtedness is over five hundred dollars per cow with a very dim outlook for the immediate future. The increase in this indebtedness was made in an effort to maintain excellent cow herd and was incurred only in maintining that herd in good condition and maintaining the ranch in a proper manner. Only a very minimal amount was taken out for living expenses. Our ranching operation has been in the family for four generations and we have always operated conservatively. I say all of this to point out the burden that an extremely volatile and erratic market has had on the ranching business.

Listed on the next page from one of the larger Oklahoma livestock markets are the high and low (average for one week) prices per one hundred weight paid for steers weighing four to five hundred pounds and the difference in the price spread.

	High	Low	Difference
Year:			
1973	78.90	51.38	27.52
1974	57.70	27.25	30.45
1975	40.85	23.70	17.15
1976	50.40	39.30	11.10
1977	48.00	39.80	8.20
1978	84.40	47.69	36.71
1979	117.60	86.50	31.10
1980	105.30	72.30	33.00
1981	81.95	64.00	17.95

It would be unfair to say that the futures market was to blame for all the ills that beset the cattle industry but when it is possible for the market price of a steer calf of the same size and quality to fluctuate four or five dollars per hundred in an hour's time at the same auction market because of a change in the futures market, then it is obvious that the live market is controlled by the traders on the commodity market in Chicago. Before cattle went on the Board of Trade, a fluctuation of as much as five or six dollars per hundred weight might occur over an entire year. Now, it is not out of the ordinary for the market to change twenty-five or thirty dollars per hundred weight over a like period of time.

For this reason there is no confidence in the cattle market. A producer cannot plan and budget for the next year. Lending institutions cannot adequately serve their customers and ranchers cannot stay in business if this situation continues.

It is totally unfair for a group to take advantage of an industry that is the backbone of the nation. A stable market for our cattle would allow a rancher to plan for the future, to maintain his productivity, conserve his resources and make a living. A stable market on the other hand would not allow the unscrupulous traders in the commodity market to gamble with our assets.

It is my solemn belief that the ranching industry cannot survive under these extremely erratic cattle prices. Please allow us to get back to supply and demand so that this great American industry can survive.

Sincerely,

ROBERT L. MILLER.

Mr. **YEUTTER**. Senator Boren, could I add one point on the English matter that I neglected earlier. Mr. Chairman, it seems to me that if the Congress were to seriously consider, as I hope it would, the possibility of giving the NFA an opportunity to function over a reasonable period of time—18 months, 2 years—Leo Melamed was suggesting 2 years in his colloquy with Senator Dole a little bit earlier—that you, Mr. Chairman, and your colleagues and counterparts in the House ought to hold the NFA absolutely accountable for its performance during that period. And if the NFA does not do as much as you feel it ought to do, or as well as it ought to do it you ought to conclude that a user fee should be imposed upon us.

But I do not think you ought to impose a user fee now before the NFA is even underway.

Senator **LUGAR**. Well, let me just conclude this particular part by indicating that the industry has mentioned I think a reasonable way of approaching the situation as we ought to try to determine the amount of regulation that is required and who will do it, the Federal Government through the CFTC or the industry through the exchanges, and then if we are able to determine the amount of what is to be done and who is to do it and who ought to pay for it and sort of in what ratios—now, in order to come to that, of course, it seems to me that the committee will need a much better idea than we have thus far—and perhaps you can help us—in giving figures as to exactly how much work is being done by the exchanges or other elements of the industry now.

Certain figures have been floated today and indeed the figures with regard to the contribution of the NFA just within this hearing this morning have ranged all the way from $6 million to $11 million, which is a substantial range. I think that we still as a committee will have to come to the conclusion as to how much of this is of value principally to the industry and the players in the markets and how much really is a total public responsibility.

I think before embracing the proposal of the distinguished Senator from Oklahoma, Congressman English or others, that we really need to take a look at the parameters of the size of our problem and who ought to pay for it, and I guess there would be some difference of opinion in totality as to just what those ratios ought to be, but if we can come to some conclusions on the total figures.

Mr. **Yeutter**. Mr. Chairman, as you know, that was the very series of points that I mentioned as we began today. Just so that we do not have a credibility problem on the NFA numbers, all of the numbers that they are using are in this document which I believe has been submitted to the committee;

Second, those numbers obviously shift, depending upon the time frame. The intent is that the NFA gradually assume more responsibilities and that the funding level rise as this is done. So when we are talking $6 million to $11 million, it may be $6 million as we move into the early part of fiscal year 1983, and then a higher level at a later time. So no one is attempting to mislead the committee, Mr. Chairman. It is just simply that we may be talking about different time frames.

Senator **Lugar**. Well, I think we are coming into a way in which we finally have to resolve this issue and it may not be one or the other. It may be some of each or—I have no idea what the resolution will be, but we will have to sort of zero in on our figures and have some idea of responsibility.

Mr. **Yeutter**. May I add, Mr Chairman, that we in the industry will be glad to provide data on what the individual exchanges are paying. As I also stated earlier in my testimony, we have begun to gather such data, but I would rather make sure that we are providing you consistent numbers and apples to apples comparisons within and among the exchanges when we submit it to you.

[The following information was subsequently received by the committee:]

BAER MARKS & UPHAM,
New York, N.Y., March 12, 1982.

Re CFTC reauthorization—costs of self-regulation.

Hon. RICHARD G. LUGAR,
Chairman, Subcommittee on Agricultural Research and General Legislation, Committee on Agriculture, Nutrition and Forestry, U.S. Senate, Washington, D.C.

DEAR CHAIRMAN LUGAR: In response to questions raised at the reauthorization hearings recently conducted by your Subcommittee, we have been requested by the industry to obtain from the various commodity exchanges, information pertaining to the costs of self-regulation for the exchanges. Included in such costs ("Costs of Self-Regulation") are such items as the costs of conducting financial audits, operating compliance departments, conducting market surveillance, maintaining a Secretary's office and a member services division, and the fees of outside counsel.

Initially, we note that because of time constraints, we have been unable to obtain necessary data from all commodity exchanges. However, based upon information that we have received from the following six exchanges, the Costs of Self-Regulation for those exchanges during their fiscal years ended during 1981 were as follows:

Exchange:	Cost of self-regulation
Chicago Board of Trade	$8,057,000
Chicago Mercantile Exchange	3,457,000
Commodity Exchange	2,992,000
Coffee, Sugar and Cocoa Exchange	2,403,000
New York Cotton Exchange	529,000
Kansas City Board of Trade	355,000
Total for six exchanges	17,793,000

In computing these costs, we asked each exchange to include salaries and other actual out-of-pocket expenses for employees and agents that perform the services described in the first paragraph of this letter. We also asked them to include a reasonable estimate of the portion of their overhead, general and administrative expenses (e.g., rent, insurance, officers salaries, fringe benefits, etc.) that should be allocated to such salaries and expenses.

Each exchange used a different method of computing the allocable portion of their overhead, general and administrative expenses, all of which appear to be consistent with good bookkeeping and accounting practices. Some exchanges multiplied their actual salaries and expenses by a factor of between two and three. Other exchanges determined the portion of total salaries represented by Costs of Self-Regulation and applied that percentage to all other expenses.

We would appreciate the inclusion of this letter in the record of the reauthorization hearings. If there is any other information that you desire, please do not hestitate to contact us.

Respectfully yours,

MARK A. BUCKSTEIN, *Partner.*

Senator LUGAR. Well, if that could come in the next week or so, we will have another hearing tomorrow, as you know, and then we will not have hearings for another week when we pick up the strain again.

Mr. BERENDT. We can certainly submit that I would hope within the next week. But on the point that you outlined in terms of the various portions that should be accountable to different segments of the industry—and Senator Boren mentioned that the question is whether the $23 million that the CFTC has is adequate for them to do their job.

I think it is important to keep in mind that with the NFA and the exchanges and also with a revision of the priorities of the CFTC and the areas they are involved in, it is conceivable that there is already enough money available to adequately regulate this industry without the imposition of an additional fee. If the regulations of the CFTC are reviewed and their resources are reallocated to the areas of most critical need, it is possible that their budget, along with the NFA and what the exchanges are spending, would be sufficient to oversee this industry adequately.

Senator LUGAR. Thank you very much for coming this morning, gentlemen.

[Subsequent to the hearing of March 1, 1982, the committee received the following letter from Edward P. Greene, General Counsel, Securities and Exchange Commission. Mr. Greene's letter addresses certain statements made by Mr. Robert K. Wilmouth, president and chief executive officer, Board of Trade of the city of Chicago. The letter is as follows:]

SECURITIES AND EXCHANGE COMMISSION,
Washington, D.C., March 26, 1982.

Hon. RICHARD LUGAR,
Chairman, Subcommittee on Agricultural Research and General Legislation, Senate Committee on Agriculture, Nutrition and Forestry, U.S. Senate, Washington, D.C.

DEAR SENATOR LUGAR: It has come to my attention that, on March 1, 1982, Robert Wilmouth, President of the Board of Trade of the City of Chicago, testified before the Subcommittee on Agricultural Research and General Legislation of the Senate Committee on Agriculture, Nutrition and Forestry concerning S. 2109. That bill would authorize appropriations for the Commodity Futures Trading Commission ("CFTC") through September 1986, and clarify the scope of the CFTC's authority with respect to options and futures contracts. During the course of his testimony, Mr. Wilmouth made certain inaccurate statements regarding the statutory responsibilities of the Securities and Exchange Commission. The purpose of this letter is to aid the Subcommittee by correcting any misunderstanding that may have arisen from Mr. Wilmouth's remarks.

S. 2109 and S. 2260, a related bill to amend the securities laws, would implement an agreement between the Commission and the CFTC reflecting what both agencies regard as an appropriate allocation of jurisdiction over options and futures on certain financial instruments. In general, that agreement provides that the SEC will regulate trading in options on securities, and the CFTC will regulate trading in futures on certain securities.[1] In his testimony on S. 2109, Mr. Wilmouth indicated his opposition to the resolution reached by the two agencies. Specifically, he stated that the SEC's function "since its formation has been to regulate and preserve the capital-formation markets" and that "everything else the SEC does, from disclosure requirements to customer protection rules, is to protect the integrity of the capital markets of the United States." He then juxtaposed this characterization of the Commission's regulatory mandate with that of the CFTC, which he defined as the regulation of trading in "risk-shifting instruments." On the basis of this purported distinction, he concluded that since both options and futures serve a risk-shifting function, they both should be regulated by the CFTC.

Mr. Wilmouth's analysis, however, is based on a misperception of the scope of the Commission's authority. In particular, the Commission's mandate is not confined to the regulation of the capital-formation process, but rather encompasses a broad range of activities relating to securities, including the regulation of risk-shifting activities and instruments.

The Commission has responsibility to administer six statutes that, collectively, have as their purpose the regulation of the securities markets and participants in those markets.[2] Certainly, Congress by means of the Securities Act, sought to regulate the capital raising process by codifying the concept of "full disclosure" in the issuance of securities and by protecting purchasers against fraud and misrepresentation.[3] Under the Securities Act, an issuer engaged in the public sale of securities (other than exempted securities) is required to register such securities with the Commission and make available to prospective purchasers a written prospectus containing, among other things, financial and other information relating to the issuer and its business and a description of the plan and purpose of the distribution.

Regulating capital formation which occurs through the issuance of securities, however, is only one aspect of the Commission's comprehensive regulation of the securities markets. While the Securities Act is concerned primarily with issuance and distribution, the Securities Exchange Act focuses principally on the trading of securities in the secondary market. That statute is designed to provide that persons buying and selling securities will have information enabling them to make informed investment decisions; to prevent and provide remedies for fraud and manipulation occurring in connection with securities trading; to provide for fair and orderly securities markets; and to regulate the extension of credit in connection with securities trading.[4]

Effective regulation in these areas clearly has a salutary effect on the capital formation process since it assures that an investor acquiring securities in an initial public offering can resell them in an honest and competitive market. The Congress, however, did not pass the Exchange Act solely to achieve this narrow goal.

Under the Exchange Act, registration and reporting requirements, combined with the regulation of proxy solicitations and tender offers, not only provide information that facilitates secondary trading, but also promote fair dealing between a corporation and its shareholders.[5] The regulation of national securities exchanges not only prevents improper trading activities, but also affirmatively promotes fair and orderly markets by, among other things, limiting marketmaker trading on exchange floors in order to reduce conflict with public orders.[6] The regulation of broker-dealers pursuant to the Exchange Act is designed to prevent fraudulent activities, safeguard financial responsibility, ensure technical competence, and, particularly through self-regulatory organizations, promote "just and equitable principles of trade." [7] Margin requirements, established by the Board of Governors of the Federal Reserve System and enforced by the Commission under the Exchange Act, protect investors against the risks associated with trading equities on thin margins, protect the securities markets from possible disruption caused by excessive speculation on credit, and also serve as an instrument of monetary policy.[8] These features of regulation under the Exchange Act clearly demonstate that the SEC's mandate goes far beyond the capital raising process.

---

[1] See Joint Press Releases of the Commission and the CFTC (Dec. 7, 1981, and Feb. 2, 1982).

[2] Securities Act of 1933, 15 U.S.C. 77a et seq. ("Securities Act"); the Securities Exchange Act of 1934, 15 U.S.C. 78a et seq. ("Exchange Act"); the Trust Indenture Act of 1939, 15 U.S.C. 77aaa et seq.; the Investment Advisers Act of 1940, 15 U.S.C. 80b et seq.; and the Investment Company Act of 1940, 15 U.S.C. 80a et seq.

[3] The Report of the Senate Committee on Banking and Currency stated that the objective of the Securities Act "is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion; to restore the confidence of the prospective investor in his ability to select sound securities; to bring into productive channels of industry and development capital which has grown timid to the point of hoarding; and to aid in providing employment and restoring buying and consuming power." Senate Report No. 47 to Accompany S. 875, 73d Cong., 1st Sess. 1 (1933).

[4] As stated in Section 2 of the Exchange Act, "transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which make it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors, and principal security holders, to require appropriate reports, to remove impediments to and perfect the mechanisms of a national market system for securities and a national system for clearance and settlement of securities transactions and the safeguarding of securities and funds related thereto, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and the Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions." 15 U.S.C. 78b.

Moreover, the Commission's authority over the securities markets specifically encompasses the regulation of a number of financial instruments and strategies which involve the transfer from one party to another of the risk of price fluctuations. One obvious example of Commission authority over risk-shifting instruments is its regulation of options. Options allow hedging against an adverse price movement in the underlying security, while at the same time retaining the opportunity to profit from a favorable price movement. A variety of spreads, straddles and other options trading strategies permit options market participants to further refine the risks they wish to bear.

The Commission's authority with respect to risk-shifting is not confined to options. Stock warrants, convertible debentures, and repurchase agreements are examples of other securities instruments that are subject to the Commission's oversight. Short sales are an example of a risk-shifting trading practice which is subject to specific Commission regulation.[9] In fact, the Commission's regulation of secondary trading in securities is an excercise of jurisdiction over risk-shifting. A transaction in the secondary market does not expand or contract the amount of capital invested in securities. Rather, the economic risks and opportunities associated with ownership merely are shifted from the seller to the buyer.

The securities laws have never drawn a distinction between risk-shifting or trading, on the one hand, and capital formation or investment on the other. Rather, they have recognized that sound secondary markets and special risk-shifting instruments and strategies, such as options, facilitate capital formation by assuring investors of fairness and flexibility in subsequent transactions. Thus, the asserted distinction between capital raising and risk-shifting simply is not one which has been employed in allocating responsibilities to the Commission.

Similarly, in reachng their accord, the Commission and the CFTC sought to allocate jurisdiction over various financial instruments in a manner conforming to the historical developments of the regulatory structure to date. The agencies considered the full range of their respective regulatory responsibilities and arrived at a solution which they believe accommodates the legitimate interests of all parties. As a result, the agreement recognizes the SEC's authority over securities, including risk-shifting aspects of the securities markets, and the CFTC's authority over futures and the markets in which they are traded.

---

[5] See Sections 13 and 14 of the Exchange Act, 15 U.S.C. 78m and 78n.

[6] See Section 11 of the Exchange Act, 15 U.S.C. 78k, and the rules thereunder. In this regard, the Report of the House Committee on Interstate and Foreign Commerce accompanying a bill which was a predecessor of the Exchange Act, stated that "[t]he bill proceeds on the theory that the exchanges are public institutions which the public is invited to use for the purchase and sale of securities listed thereon, and are not private clubs to be conducted only in accordance with the interest of their members. "Report to Accompany H.R. 9323. H.R. Rep. No. 1383, 73d. Cong., 2d Sess. 15 (1934).

[7] For example, Congress in amending the Exchange Act to provide for national securities associations envisioned that self-regulatory organization of this type, among other things, would "cope with those methods of doing business which while technically outside the are of definite illegality, are nevertheless unfair both to customer and to decent competitor, and are seriously damaging to the mechanism of a fair and open market." Report of the House Committee on Interstate and Foreign Commerce to Accompany S. 3255, H.R. Rep. No. 2307, 75th Cong., 3rd Sess. 4 (1938).

[8] According to the House Committee on Interstate and Foreign Commerce, the margin provisions of the Exchange Act were intended in part "to give a Government credit agency an effective method of reducing the aggregate amount of the nation's credit resources which can be directed by speculation into the stock market and out of more desirable uses of commerce and industry." H.R. Rep. No. 1383, 73d Cong., 2d Sess. 8 (1934).

[9] Sections 10(a) and 16(c) of the Exchange Act, 15 U.S.C. 78j(a) and 78p(c).

Sincerely,

EDWARD F. GREENE,
General Counsel.

The Chair would now like to call on an additional panel: Mr. Bennett J. Corn, president of the Coffee, Sugar & Cocoa Exchange, Inc., New York City; Mr. David Morgan, president of the MidAmerica Commodity Exchange, Chicago, Ill.; and Mr. Robert Batte, and Mr. Walter Vernon, from the Kansas City Board of Trade.

If you will proceed, we shall try to offer as good a hearing as possible, but if you could summarize for a 10-minute period of time, your presentations would be very helpful and we will then proceed to the questioning.

Mr. Corn, would you proceed, please.

STATEMENT OF BENNETT J. CORN, PRESIDENT, COFFEE, SUGAR & COCOA EXCHANGE, INC.

Mr. CORN. Thank you, Mr. Chairman. My name is Bennett J. Corn. I am the president of the Coffee, Sugar & Cocoa Exchange in New York City. I would like to summarize my statement but ask that my prepared statement [1] be included in the record in its entirety.

Senator LUGAR. It will be so included.

Mr. CORN. Thank you.

Our exchange strongly supports the reauthorization of the Commodity Futures Trading Commission. We believe that it has come into its own as a responsible and effective regulatory agency. In particular, we believe that under the administration of Chairman Johnson, the Commission has made great progress in establishing a regulatory system that recognizes the practical needs of the industry without compromising the basic goal of protecting the futures markets and the public interest.

A number of proposals for amending the Commodity Exchange Act are being put before this committee. Although I do not plan to go through them point-by-point, there are a few which I would like to highlight.

The most troublesome is the CFTC proposal which would give the CFTC power to impose so-called user fees, which would be nothing more than a tax levied exclusively on the users of the futures markets. There is no justification for this type of discriminatory tax. It would place an unwarranted burden on an industry that is already spending huge amounts for regulatory purposes.

Since the CFTC first came into existence, the exchanges have expended vast sums on the regulation of the futures markets. To take just our exchange, in 1976 our total regulatory expenses came to $149,000. Five years later, in 1981, our regulatory expenses came to $2,400,000, an increase of over 1,600 percent. Our compliance and auditing staff has grown from two persons in 1976 to 23 in 1981. At a cost of $1 million, we have installed a computerized trading surveillance system, which is by far the most sophisticated, and effective in the industry. My current 1982 regulatory expenses will be approximately 50 percent of the total operating budget of the Coffee, Sugar & Cocoa Exchange, and I can only foresee the percentage growing in the ensuing years.

---

[1] See p. 411 for the prepared statement of Mr. Corn.

Senator Boren. What percentage was that? Excuse me.

Mr. Corn. Approximately 50 percent.

These costs are largely borne by our members through transaction charges collected by our clearing organizations. In some cases, brokerage firms have been able to pass those charges on to their customers. However, the floor traders, who provide the needed liquidity in our markets, and the commercial firms, which are the principal reason for our existence, have no customers to pass these charges on to.

There is another insidious facet of the user tax and that is its potential impact on the National Futures Association [NFA]. A large number of firms dealing with the public in one aspect or another of the commodity business have not been adequately regulated by the CFTC or by the exchanges.

One of the primary functions of NFA would be to take over the regulatory responsibility for this sector of the industry. Another would be to relieve the CFTC of other costly tasks, such as the registration and proficiency testing of professionals, financial surveillance of nonexchange members and auditing of sales practices. The assumption of these obligations by NFA would have the dual benefit of improving public protection while reducing CFTC costs of operation.

However, the fact is many exchange members in Chicago, New York and elsewhere have stated that they will oppose NFA if user taxes are imposed. It is not that they are unwilling to pay their fair share; they are simply unwilling to pay twice. Given the knowledge, experience, and beneficial self-interest of those who will be responsible for, and bear the cost of NFA, the fundamental question it seems to me is whether efficient and cost-effective self-regulation will be given the opportunity to succeed or whether inefficient and costly Government regulation will be expanded. To me, the answer is obvious.

The exchanges have proven that self-regulation can and does work. The industry is willing to assume the additional burdens of filling the many regulatory gaps I have already mentioned by funding the NFA. I believe the NFA should be given the opportunity to succeed. It should not be permitted to founder as a result of a user tax because such a result would serve neither the Commission nor the public interest.

For all these reasons, we urge Congress not to adopt the user tax.

Also of great concern to us is the proposal to empower the Commission to become more involved in our day-to-day operations. Currently, under section 5a(12) of the Commodity Exchange Act, the CFTC must approve all exchange rules that relate to terms and conditions in futures contracts or other trading requirements, other than those relating to setting levels of margin. This provision has been one of the greatest impediments to self-regulatory efforts by exchanges since it became effective in 1975. We estimate that currently each rule filed for approval has taken an average of approximately 4 to 5 months to be acted upon.

There has been a great improvement in the processing of rule approvals during the Johnson administration. However, we still have rules that have been before the Commission for as long as 5 years, even rules that the Commission itself required us to adopt.

Accordingly, we have, in conjunction with the other exchanges, developed a proposal for amending section 5a(12) that will alleviate these problems. That amendment, together with a detailed supporting statement, is contained in the recommendations for a Futures Trading Regulatory Improvements Act of 1982 prepared by members of the futures industry and separately submitted to this committee.

We enthusiastically support that amendment and urge its adoption. At the same time, we urge the defeat of the amendments to section 5a(12) proposed by the CFTC because they expand the review requirements and do nothing to speed the process.

We urge adoption of the CFTC proposal which would enhance the role of the States with respect to policing off-exchange commodity frauds. That proposal would provide explicitly that other Federal and State laws may be applied to prosecute such frauds. Further, State attorneys general and securities administrators would be authorized to take action either in court or administratively against boiler room operators and any persons engaged in CFTC-regulated activity if they were not registered or designated by the Commission.

In light of the Commission's evident inability to combat fraud in the offer and sale of off-exchange commodity investments, and because any and all fraud taints the entire industry, we support its proposal. We, however, caution against and strongly oppose any amendments to the act which would diminish or interfere with the Commission's exclusive jurisdiction to regulate any segment of the industry.

Another CFTC proposal which we strongly oppose is the proposed amendment to section 13(b) of the act, which would make any person who controls another (without defining the term control) responsible (without saying how or in what way) for violations of law by the person who is controlled. No justification has been given for this radical extension of the act.

The CFTC proposal could even have an impact on exchanges if under certain circumstances an exchange might be deemed to control its members. In addition, it could result in officials and even unpaid board members of exchanges being held responsible for acts or omissions of the exchange staff. Among other things, this could have the undesirable effect of discouraging public members from serving on exchange boards.

This proposal is ill conceived, and it should be defeated.

The last industry proposal upon which I would like to comment is the suggestion to amend section 8a(9), which gives the Commission extraordinary power to direct exchanges to take any action the Commission deems necessary to maintain or restore orderly trading whenever the Commission believes that an emergency exists.

To the great surprise of the entire industry, a court of appeals recently held that action by the Commission pursuant to section 8a(9) is not subject to judicial review. It seems inconsistent with the fundamental principles of our society for any agency to have the kind of ultimate power that section 8a(9) confers with no judicial review whatsoever. Accordingly, the industry has proposed, and we strongly recommend, that the act be amended to provide expressly for judicial review of CFTC emergency actions under section 8a(9).

I thank you for this opportunity to present our views. I will be pleased to answer any questions you may have. Thank you.

Senator LUGAR. Thank you very much, Mr. Corn.

Mr. Morgan, would you proceed, please?

STATEMENT OF DAVID H. MORGAN, PRESIDENT, MIDAMERICA COMMODITY EXCHANGE

Mr. MORGAN. Good morning, Mr. Chairman. I am David H. Morgan, president of MidAmerica Commodity Exchange, in Chicago. We have a prepared statement which we would like to have appear in the record.[1]

Senator LUGAR. It will so be recorded.

Mr. MORGAN. If the subcommittee would permit it, I will summarize briefly our views on key matters contained in our formal statement.

MidAmerica provides smaller producers, merchants, and users of agricultural commodities with the opportunities for risk-management benefits associated with the futures markets. We do this by having the capability to offer smaller-sized contracts in grains and livestock, and through the existence of our changer procedure, a unique form of institutionalized arbitrage between MidAmerica and other larger exchanges. We are proud of the success of these smaller-sized contracts and of their high utility to agricultural producers in conducting hedging programs. A recent survey indicated that over 70 percent of the open interest in our live hog contract.

Smaller exchanges will be affected profoundly by the outcome of the reauthorization hearings since they are the most vulnerable to adverse economic conditions, delays in contract and rule approval, and inefficient and oppressive regulation. We believe that MidAmerica is quite representative of the smaller exchanges and that we share in common many problems with respect to regulation.

We are one of the oldest U.S. exchanges, founded in 1880. We like to say that we have survived in our 100 years the Great Depression, 22 Presidents, 5 wars, and 7 years of the CFTC. [Laughter.]

We are here today because we are not all that sure we will so handily survive the next 4 years of the CFTC, without some changes in the act to give us a better opportunity to compete with other U.S. exchanges.

While we support reauthorization of the CFTC as the sole authority to regulate the futures markets, we are suggesting amendments to the act. At the same time you will not be surprised to hear that we are opposing some of the amendments the CFTC is proposing.

---

[1] See p. 419 for the prepared statement of Mr. Morgan.

Since the number of proposed amendments we strongly oppose is fewer than those we support, let me first comment on those which we oppose:

First, we oppose regulatory taxes in the name of transaction fees. They interdict progress of NFA, which we believe is a real alternative to the voids and excesses of Federal regulation. They make a small number of traders support an institution where the public derives the major benefit. As opposed by the CFTC, they do not contain the necessary safeguards to insure that regulatory business as usual will not continue to expand. From what we have seen, exchanges have derived little benefit from the CFTC to date.

Second, we oppose committee action (at this time) on the so-called CFTC/SEC accord on procedural and substantive grounds. We believe that for the committee to act at this time on this proposal without assurance from the Securities Oversight Subcommittee that it will also honor the agreement is courting major potential problems in our industry. In the House, Congressman Dingell has introduced a bill calling for a moratorium on stock indexes—a key agreement area of the accord.

We have seen an escalation of attacks on cash settlement—another key agreement area of the accord—for the same and other futures contracts.

Finally, as the CFTC's amendments to implement the agreement are drafted in S. 2109, Congress must first act on amendments to the Commodity Exchange Act. Yet, our indication is that this is not likely to happen in the order contemplated, for there is some opposition elsewhere. For these reasons the amended language should be separated from CFTC reauthorization to be held until Congress first acts on securities regulatory issues.

We see little reason for the CFTC giving up as much of its jurisdiction over options—risk-shifting market instruments—as the accord contemplates. Ceding jurisdiction to the SEC in options on foreign currencies and on exempt securities are examples. All exchange-traded instruments on anything but listed securities properly should be regulated exclusively by the CFTC.

Third, we also strongly oppose section 4 of the CFTC's proposals, replacing the act's provisions on speculative limits with informal Commission rulemaking authority. Instead, we think the act's speculative limits provision should be rewritten to bring it more in line with current economic thinking, and we support language generally along the lines of the industry draft proposal submitted to the members of the subcommittee on Monday of last week.

Fourth, we strongly oppose a grant of State jurisdiction that will have the effect of stifling the markets or limiting liquidity. Regretably, there are two markets at issue with respect to commodities. There is the traditionally oriented mainstream exchange futures and options commodity marketplace which justifies its existence by providing a forum for hedging and price discovery, and there is the marketplace in fraud that uses commodities as an excuse for its existence. The former must be protected from State security jurisdiction; in the latter, the CFTC needs all the help it can get.

Now, as to what we support: We favor amendments regularizing the act's current contract market approval process. Under existing law, when an exchange proposes a new contract to the CFTC, there is no provision that forces the CFTC to make a decision on the application. In point of fact, what often happens is that the staff will simply tell an exchange that it will not process an application unless the exchange makes certain amendments to the contract.

This has the effect of denying the application, often indeterminately, but the act provides an exchange no remedy to get a hearing on this sort of denial. Under current law, only if the Commission officially disapproves the application, would the exchange be provided with an opportunity for a hearing on the record of the denial, and we propose that the act be amended to eliminate that anomaly.

We are currently winding our way through the CFTC contract designation process with our proposed Treasury bill contract. As I sit here, our contract, similar in specifications, save for size, to the highly successful T-bill contract traded on the Chicago Mercantile Exchange, has been before the CFTC 893 days—yes, since September 1979—and we have yet to get an official decision from the CFTC on the contract. New contracts are the livelihood of the futures industry, and we have been denied an important transfusion.

The subcommittee, I am sure, recognizes that when markets are flat, as farm markets have been recently, there is minimal trading in those commodities. Our markets exist for risk-shifting. The older agricultural contracts we trade, the backbone of MidAmerica's service over many years, have dwindled in volume during the last year. Over 42 percent of all 1981 futures volume can be traced to contracts introduced in the last 10 years, such as financial instruments, and to a certain extent, gold.

It goes without saying, as our experience has borne out, that without an adequate complex of financial instruments to trade, MidAmerica's overall share of volume will continue to decline. Thus, it is a real hardship for a small but publicly popular exchange, such as MidAmerica, to be shut out of an important segment of the market for over 2 years, when larger exchanges down the street are booming.

Yet this is the situation at MidAmerica with respect to our attempts to enter the Treasury bill marketplace. The CFTC staff said the contract would draw down on deliverable supply, even though the Federal Reserve said it had no objection on that basis to approval of the contract. Nevertheless, the CFTC staff would not back off its position, so we amended the application.

The staff then suggested another amendment. We made it. The staff told us we were then in line for early approval, but suddenly again the contract was not to be forwarded.

In the middle of the process, the staff division at the CFTC ceased processing contract applications while it engaged in a study mandated under section 21 of the act. Finally, in order to get rid of any deliverable supply problem, we agreed to go to cash settlement. This led to suggestions that the contract might be approved in January of this year, but the Commission, instead, directed the staff to move another contract. So it has gone.

Throughout this period, we have had no remedy to counter this bureaucratic ambivalence. We strongly believe the process has to be changed, that a 6-month deadline has to be put on the CFTC either to approve or deny contract market applications. We believe that there is nothing unfair about this proposal, since the CFTC also puts a deadline on exchanges to respond to its inquiries; if exchanges do not meet the deadline, the CFTC deems the contract dead. We want parity.

We also support several other amendments to the act. We would like to see its antispeculative bias removed, and we have recommended, in the case of contract market designation, the rule approval process also be governed by time limits. We would particularly like to see exchange options on domestically produced agricultural products approved, since we think this could be highly useful to producers and processors alike.

We hope the members and staff will have time to study our formal statement, which amplifies my comments here. Thank you, Mr. Chairman.

Senator LUGAR. Thank you very much, Mr. Morgan.

Mr. Batte, will you be testifying on behalf of Kansas City?

Mr. BATTE. Yes.

Senator LUGAR. All right, go ahead.

STATEMENT OF ROBERT BATTE, FIRST VICE PRESIDENT, KANSAS CITY BOARD OF TRADE, ACCOMPANIED BY WALTER N. VERNON, CHIEF EXECUTIVE OFFICER

Mr. BATTE. Mr. Chairman and members of the committee, my name is Robert Batte. I am a member and first vice president of the Kansas City Board of Trade. My associate is Walter Vernon, the chief executive officer of our exchange.[1]

The Kansas City Board of Trade supports the reauthorization of the CFTC and would like to offer the following suggestions for your consideration during the reauthorization process:

We recommend that the CFTC be reauthorized for a period of 6 to 10 years. Other Federal agencies are not required to seek reauthorization every 4 years. Senate and House bills to establish sunset legislation for all Government agencies suggests that the appropriate time for reauthorization should either be 10 or 20 years.

The present 4-year reauthorization cycle is time consuming and costly for both the Congress and the industry. In addition, we believe that the brevity of the present cycle retards the normal development of agency programs and policies, heightening the political environment in which the Commission must operate. A longer term would create a more stable Commission.

We suggest that the role of the CFTC be reexamined by an advisory committee, in light of the establishment of the NFA. That committee should also study the imposition of user fees which would be directly related to services provided by the CFTC. We believe that such a review conducted by an advisory committee made up of experts from various markets, industry users, Government officials, and management experts would result in sound recommendations to Congress as to the scope of the CFTC's oversight activities as well as an equitable distribution of the costs involved.

The Kansas City Board of Trade is acutely aware of the budgetary pressures which face the Congress, the administration, and the American people. However, we do not think that a uniform tax on all commodity market users is appropriate. By way of example, the imposition of such a tax on agricultural hedgers would result in yet another cost being transferred to farmers already burdened by declining farm prices and escalating costs.

---

[1] See p. 441 for the prepared statement of the Kansas City Board of Trade as presented by Mr. Batte.

The exchanges, as self-regulatory bodies, could continue to regulate the conduct of their respective members while the NFA could undertake regulation of the FCM's dealing with the public. Both are under the general oversight of the CFTC.

We recommend that the Congress ratify the recent CFTC/SEC agreement. In recent years, we have witnessed a virtual explosion in new futures contracts and contract proposals, many of which are financial in nature. The agreement between Chairman Johnson and Chairman Shad was a very practical attempt to deal with the areas where the functions of their respective commissions overlap. The Kansas City Board of Trade applauds this very sound approach to a vexing problem.

Congressional ratification of the agreement would eliminate the industry's difficulties with duplicative Federal oversight.

The Kansas City Board of Trade is opposed to any change in present law which would permit trading in options on agricultural commodities such as wheat.

We have reviewed this matter with members, as well as other industry experts who were active during the 1930's when such options were traded. The uniform conclusion of those experts was that options did not serve as a satisfactory method of trading because the premium paid for the option was out of proportion to the economic benefit derived.

We understand that the National Grain and Feed Association has suggested that a study of 1 to 2 years in length be conducted prior to approval of trading in agricultural options. At the very least, we urge the Congress to follow that suggestion.

In general, we support the commodity industry proposal on reauthorization. However, we do oppose the imposition of time limits on new contract proposals.

There has been some confusion over the word margin, since it is also used in the securities industry, where it refers to an extension of credit for the purchase of securities. By contrast, the word margin as used in commodities means a customer deposit. It serves as an earnest money deposit which guarantees performance. Both the buyer and the seller put up a deposit and nothing is purchased. Thus, the Kansas City Board of Trade recommends that the word margin be changed to customer deposit.

We sincerely appreciate the opportunity to express our views to this committee. We believe that the CFTC is an important regulatory agency, with a legitimate, albeit evolving role to fulfill. We urge that it be continued as a separate Commission. We recognize the call in some quarters for its inclusion in a U.S. Commission on Exchanges, but respectfully suggest that there is a distinct functional difference between commodity trading (hedging) and that of other markets (such as capital formation and secondary trading of equity securities).

In the event that you require additional information, we would be happy to supply it at your request. Thank you.

Senator **Lugar**. Mr. Batte, let me ask you right away, because on page 5 of your statement you make these statements and I want to make certain that I understand your testimony.

You say that you have reviewed the matter—this is on the agricultural options—of members as well as industry experts who were active during the 1930's, and on the basis of that review you come to the conclusion that options do not serve as a satisfactory method of trading.

Mr. **Batte**. Yes; the price paid for the option was out of proportion to the benefit derived.

Senator **Lugar**. Mr. Morgan, in his testimony, of course, suggested that would be an area that might be opened up—as I understood your suggestion, it ought not to be.

Let me frame one other difference that I see before asking you and Mr. Morgan perhaps for the benefit of the committee to discuss different points of view. You say in general the Kansas City Board of Trade supports the commodity industry proposal on reauthorization. "However, we do oppose the imposition of time limits on new contract proposals."

The burden of much of Mr. Morgan's testimony and others, for that matter, has been that the need for time limits, even of 60 days duration that Senator Dole in his colloquy was suggesting, was imperative. Why do you come to these conclusion, first of all, and then open it up to Mr. Morgan or Mr. Corn for their comments?

Mr. **Batte**. Well, with regard to time limits on new contract proposals, we simply believe that the Commission has demonstrated during Chairman Johnson's term that they have the capacity to deal with new contract applications in an effective manner and we do not see the need for it.

Senator **Lugar**. How about the agricultural futures situation? Does simply your study indicate that this is an undesirable thing to open up, or do you have any further comment about that?

Mr. **Batte**. Simply that we believe that the existing——

Senator **Lugar**. Options.

Mr. **Batte** [continuing]. That the existing futures markets perform the function that would be required and that the experience would seem to indicate that the economic benefit derived from the purchase of an option on a broadly traded futures contract such as an agricultural contract would exceed its utility.

Senator **Lugar**. Mr. Morgan, do you have any further comment to follow up your earlier testimony?

Mr. **Morgan**. Well, with respect to the difference in our testimony as regarding the need for time limits on the approval of contract market designation, I have not talked with Kansas City on this but I think our testimony speaks for itself.

If you are in a situation where you are attempting to trade a contract that is patterned virtually 100 percent along the lines of the contract that is one of the most successfully traded contracts in the country, there is a great demand for financial instruments, and yet because of this one variance, namely the size of the contract being half the size of the other one, there seems to be some sort of a problem.

Now, aside from denying us the opportunity to offer this to the public, there are a couple of other comments I would like to make.

First of all, it certainly denies the exchange, a well needed source of revenue. I would estimate that had we the opportunity to have been trading this contract over the last year, given the performance of the other contracts, that perhaps our revenues could have been increased by as much as 25 percent.

I think the other thing though that should be borne in mind is if this is an example of the application of the human resources that the Commission makes, namely to this sort of thing, it seems to me that those resources could be put to better use on behalf of the public were they directed to other kinds of functions.

So I think that our feelings about this is quite strong. We are not asking for anything that we think is out of line. Certainly, as we have said, we are accountable in terms of our timely response to what the Commission asks, and we do not think that this would subject them to any kind of a burden that they do not now have.

With respect to the business of options on agricultural commodities, we felt that this was important to bring up at this time because we had had some discussions with people who had indicated that perhaps it is time to reevaluate this subject.

Going back into the thirties puts us in an entirely different era with respect to speculation in the treatment of the farm markets. I certainly would not disagree with the trade association's recommendation that this matter be studied. On the contrary, I think it should be. What our testimony attempts to point out, Mr. Chairman, is this is now the time to take a look at it and see if there can be a benefit to the producer and let us see if we can expand the role of our markets.

Senator **Lugar**. Senator Boren, do you have questions of the witnesses?

Senator **Boren**. Did I understand you to say earlier in your testimony—I think you said it—that of the transactions entered into, that something like 60 to 70 percent were entered into by producers?

Mr. **Morgan**. No, I referred to—the popularity of one of our contracts is our small size hog contract, where we have a tremendous amount of interest on the part of the hog producers in that contract and they do maintain large open interest positions in the contract. There is always a question in people's minds as to whether just how much interest the hedging side has on contracts. We really pointed out that we do serve that kind of purpose at Mid-America.

Senator **Boren**. Have you been able to determine at all, percentagewise, what share of the market that is?

Mr. **Morgan**. No, sir, we have not. We do know that some of the very large hog producers use our market extensively and that is about as far as we have really gone.

Senator **Lugar**. Mr. Batte, I understand that the Kansas City Board of Trade recently authorized a transaction fee on your members. What is the nature of this fee? How much is it? Why did you impose it? Can you give us any information about that situation?

Mr. **Batte**. The fee is a dollar per contract.

Senator **Lugar**. One dollar per contract?

Mr. **Batte**. For nonmembers.

Senator **Lugar**. Nonmembers?

Mr. **Batte**. 50 cents per contract for members. Excuse me, I am wrong. The new contract, stock index, is $1 per trade and the wheat contract, the existing contract is 3 cents.

Senator **Lugar**. I see.

Mr. **Batte**. The purpose of the fee is to fund our own self-regulatory efforts. It creates income with which to operate the exchange.

Senator **Lugar**. How much money is likely to derive? How does that fit into your budget?

Mr. **Batte**. As I recall it, if my memory serves me correctly, the wheat contract generates something on the order of a quarter of a million dollars. As far as what the new one will generate, no one knows. It is a brand new contract. We started trading it on Wednesday, and the potential volume is yet unknown.

Senator **Lugar**. Mr. Vernon.

Mr. **Vernon**. May I comment briefly on that, Senator.

Senator **Lugar**. Yes.

Mr. **Vernon**. The Kansas City Board of Trade previously did not have fees of this nature. It financed its operations on interest earned on customer deposits. However, at the request of quite a few of our commercial members, exporters, millers, farm co-ops and others, we have changed our system so that we no longer require cash deposits. We will accept T-bills or cash. As a consequence, it is necessary to pay the rent, as it were, so we have shifted—we have not really changed—we have merely shifted the method of paying our operational costs, and I think that the co-ops that use our market and others have accepted this change.

Senator **Lugar**. Now, how is it you oppose the idea of a CFTC transaction fee presumably on the same grounds that others have testified that the NFA is going to be the way that the industry polices its members and offers some assurance to the public and that that in itself will be a very substantial levy—I do not want to put words in your mouth—but why, given this transaction fee that you have adopted for your own purposes, would you not favor the Federal Government taking a look at the situation in terms of costs of the Commission and trying to finance the costs in that manner?

Mr. **Batte**. Well, we would suggest that not only the Kansas City Board of Trade but probably every major exchange has a transaction fee of one sort or another through which they fund the operations of the exchange. We are opposed to the users fee as it is currently proposed in the form of a transaction fee because we think it places the burden of cost of regulation on the wrong people. We believe the NFA will be able to deal effectively, very effectively with the FCM community and the public participation area of the market, and we think, as we have suggested, that the exchanges, our exchange certainly, are willing to pay user fees which relate to services which we would receive directly from the Government, but we believe that the futures markets serve a public function and that a certain amount of the CFTC's regulatory activities are in the "public" good and should be funded from appropriations.

Senator **Lugar**. Well, that may be true and, of course, with our last panelists, you were listening when we were trying to weigh what the total cost is, who ought to do the job and how it should be allocated, and honest men and women will differ on that, I am sure, but the question in turn will come back to whether $20 million or $23 million or whatever the budget of the CFTC might be, is totally in the public interest as opposed to the primary interest of those who are involved in the market. I suppose that is what we are trying to weigh--and to what extent any of that levy ought to be borne by the markets or the users of the markets.

Now, almost uniformally industry people today have opposed the imposition of a levy by the CFTC on a user basis, with the thought that the NFA would be picking up portions and maybe the rest of it ought to be handled by the public anyway. Is that generally your testimony, or do you vary at all from what we have heard previously?

Mr. **BATTE**. Well, we are only suggesting—the only difference between our testimony and the testimony of the rest of the industry is that we are suggesting that the Government should study the activities of the CFTC in light of the establishment of the NFA, with an eye towards making some judgment as to the allocation of those costs.

Senator **LUGAR**. That is probably a point that is well taken. My guess is, however, that this is the study that is going to occur. [Laughter.]

I think this is the time to finish it, when we finally come to that point every 4 years, and you suggest that it might be delayed once every 6, 10, or even 20, and an optimum standpoint that is what the Congress will determine, although I presume, as earlier testimony suggested, when we went through this process 4 years ago, the whole business was in some jeopardy, as you may recall, the whole thing as to whether we would have reauthorization of the CFTC, or much of an industry for that matter, or if we did have one, the type, how strict it might be or under the SEC or various other candidates. Now, we sort of moved out of the dark shadows and had happier times I would think in the last 4 years.

We have come now to that point where this subcommittee and the other committee in the Congress will make a study and will have to make some judgments. So this is why we are pointed in trying to get to the answers and this is the sort of time to speak up.

Mr. Corn, you have been denied an opportunity to speak throughout all of this colloquy, and I can see that you are eager to do so and I recognize you. [Laughter.]

Mr. **CORN**. Your earlier questions regarding rule approval, we support the proposals submitted earlier and the main reason why is there will be a time within 60 days the Commission will have to either approve or deny approval of a rule, and I think that is very important. We have had in our experience at the exchange an average of 4 to 5 months time in getting rules approved. We have a number that are still sitting there for several years.

I think it will require the Commission to act, whereas now they do not have to act, they just sit on the rule or they can sit on the contract, as Mr. Morgan has explained.

Your other question that came up about options, I wasn't around back there in the 1930's, but I think options, whether it be on domestic agricultural commodities or on a commodity like the one we intend to trade on sugar options and hopefully eventually coffee and cocoa options, will provide an acknowledged service to producers and end users.

There have been many concerns on the part of farmers and cane growers and in particular there was a study done several years ago at Louisiana State University that showed that the small farmers that produce cane sugar were not in the futures market and should be, and one of the reasons why was the exposure to margin calls. The difference between right and wrong sometimes is the staying power of the market participant when the market moves against him, and one of the things that the study pointed out is that an options program in sugar would be very beneficial to the small producers and users in that they would be obtaining that hedging protection for a time certain and not be subject to the variation market calls.

With respect to the user fee, I think one of the things that—I wish was made a little clearer in the testimony today by various people from the industry—was that there has been mention of the growth of this industry and the growth really is taking part on the exchange contracts. The FIA, which is a Futures Industry Association, has many times stated that its members account for approximately 80 percent of the futures trading buying that takes place on exchanges, and I would dare say that the majority of all of their members are members of exchanges and the exchanges are regulating the member FCM community which the Commission, Congress and the public do not seem to have a great deal of concern with. It is the nonmember FCM who is not regulated by any exchange which the NFA would now regulate. The CFTC has not had the adequate resources or expertise to deal in this area, and it is this area that has given the whole industry a black eye.

I think the real issue is whether you are going to have a user fee and only the CFTC and exchanges regulating and protecting the public or you are not going to have a user fee and you are going to have a third entity protecting the public called the NFA. The facts are that many of our members, whether you agree or disagree with them, have had significant difficulty in understanding and believing in the utility benefits of the NFA. We have overcome that issue and now they are being told they are going to pay a user fee. For whatever reason, I think various segments of the industry will not support the NFA and user fees.

The question in my mind is are we better served with exchanges that have no oversight over nonmember FCM's and the CFTC, or allow the NFA to develop. The various numbers that have been thrown around this room as to how much the NFA will save the CFTC or will not save the CFTC can be sorted out later. I think the one number I feel comfortable with is the amount of money that the exchanges are spending in the self-regulatory process.

As I said earlier in my testimony, it is somewhere in the area of $2.4 million and will continually grow, and we are not the largest exchange by a long shot. We fall somewhere in the middle. There has got to be in the area of $15 to $20 million spent on exchange regulatory programs, and it is an efficient regulatory program. Some of the most significant regulation of member FCMs where public interest and public concern should be because of the FCM holding of customer funds and dealing with the bulk of the transactions on the markets is where the exchanges do a very extensive joint auditing program. There are two of them in existence. They are approximately 2 years old, I believe, and we are constantly improving them.

That is where the bulk of the futures trading is centered, with the member FCMs and the exchanges and they are meeting their regulatory obligations.

Senator **Lugar**. Mr. Corn, I have no doubt that your analysis is correct, that 80 percent of the trading more or less is in a fairly regulated way in response to the industry is taking care of the public and, as you say, the problem is in this off-exchange business, the extension of service that might be offered by the NFA. Of course, the figures may become more clear as we all do more research in this.

Essentially what you are also saying, it seems to me, is that the work the CFTC is not able to do well now that might be performed by the NFA means that there would not necessarily be a lot of transfer of the CFTC's budget, that we are really talking about an additional extension of enforcement into the dark reaches of the commodity business.

The problem it seems to me comes down to whether the basic $20 million now being paid for the budget ought to be essentially the obligation of the general taxpayers of the country as opposed to being shared by some of those who are involved. It is not meant to be a capricious analogy, but in one of my previous areas of public service as mayor of a city, we had a situation in which the golf courses were losing a lot of money in the sense that the public as a whole was paying for their maintenance and the thought came at least to some of us that those who were using the golf courses by paying higher greens fees ought to essentially make this a break-even situation. That was objected to by almost every golfer in the city of Indianapolis who felt that there was a public interest in the beauty of the courses and the ecological values of this and having a park system in any event, and maybe in general health and recreation of our members of that society.

But even given those strong objections, we did raise the greens fees and, as a matter of fact, balanced the budget. Now, to what extent is that analogy not applicable to the exchanges, granted that it is a very serious purpose not a recreational one that is provided by the exchanges, but there are persons utilizing them potentially for profit, for gain and doing reasonably well at it, and to what extent ought the public bear all of that, part of it—that I think is the major sort of decision we are going to have to make after we see the parameters of the figures.

Mr. **Batte**. Being a golfer, Senator, I can sympathize with your friends who did not want to pay higher greens fees. But aside from the fact that perhaps the golfer's wife benefits from his presence on the golf course as opposed to being home on Saturday morning, it is not a direct correlation. There are a great many people who benefit, producers of various agricultural commodities. The benefit is passed back, while the farmer, for example, is not a direct participant in the wheat market, he does benefit from a decline in price swings which occurs as a result of the existence of the futures market. So I do not think that the correlary is as direct as you would suggest.

Senator LUGAR. How many people in our society, however, would benefit from all of this apparatus we are discussing today? One million? Two million? Are there 200 million Americans who are not the slightest bit affected by this system but picking up the tab?

Mr. VERNON. Those of us in the industry can say that every housewife that buys a loaf of bread or a cup of coffee or a package of sugar to bake a cake, et cetera, all benefit from the futures markets. The futures market works well for the hedger, it means that the hedger can operate on a narrower profit margin and thus is able to pay the producer more and charge the consumer less. We think that everyone in America benefits from active, effective, well-regulated markets.

I want to go back to the point about the CFTC. I think all of the industry testimony has been that we need to take a second look at the CFTC. Some of the industry proposals, for instance, would suggest that in the rule approval area we are much improved today. The NFA proposal suggests they can take over the functions that the CFTC is now performing and do them more effectively at no cost to the Government. It seems to us that there are areas where it is not just continuing the ballgame as usual but taking a new look at the situation.

Senator LUGAR. I hate to prolong the hearing, but let me ask just one more question. You have mentioned, at least two of you, Mr. Corn and Mr. Morgan, this period of time that is required for rules to be promulgated or denied or in some cases nothing happens at all.

Why is this so? I grant that bureaucratic inertia may be one reason and, if so, the 60-day limit cured that, I suppose. But in many public policy questions, and all of you have experienced it, some questions are not ripe for solution on occasion. One reason why you do not either say yes or no is that by and large there were conflicting points of view that are in the process of being reconciled, or there are vastly different changes or there are circumstances that were not contemplated by precedent, and I think this we all understand.

But your testimony apparently takes all of that into consideration but still says that in a 60-day period almost any rule change, however off the wall or reasonable, as the case may be, you ought to be able to reach a decision, and if you say no then presumably there must be some appeal to that, the reasons for the no have to be given, and even you are suggesting perhaps the NFA might take over some of this rulemaking, and if so would that be in the same public interest or is this an industry group then without the checks and balances that the public purpose, sort of promulgating the new rules for the economy of both that are involved in it.

In other words, I was trying to take a fix on whether Chairman Johnson's testimony, which is essentially one not putting any limits on, from his experience, which is substantial, ought to be weighed pretty heavily, as opposed to most of the testimony we have heard from the industry today which suggests that there really has to be a fixed time on every rule. Are there differences in rules? Are there some kinds which ought to have a limit on and some kinds you should not?

Mr. CORN. First of all, I do not think the NFA should be put in the position where it would approve exchange rules. I think what they have been saying is by taking over certain responsibilities that the CFTC currently has, the CFTC will have resources to put into the rule approval process and speed that along.

I am not saying that every rule that is submitted by an exchange is always perfect and the CFTC is always wrong in coming back to an exchange and saying there is something wrong. But I am saying that a far greater majority of all submissions, at least the experience of our exchange, has been that we get a 30-day letter saying they are unable to approve and then that is the end of it and we go back and forth on the telephone and our staff people work with the Commission people and 3, 4, 5 months later we finally get approval. We are not always told why there is a problem. In some instances we are told that we have a problem with the rule and there is a discussion, but in some instances we are not told anything.

I think what we are saying in the industry proposal is that there be a requirement on the Commission to come back and tell the exchanges explicitly what is wrong with their submission and if they have a problem with the rule, or they are discussing broad policy which affects the industry and we are not aware of it, we ought to know that. Instead, we just get a standard word processor letter that comes out and says we are unable to approve in 30 days and we have tremendous pressures from our membership which is looking to implement anything from housekeeping to an economic condition of a contract.

Senator LUGAR. Mr. Morgan?

Mr. MORGAN. Just a couple of comments along the same line, Mr. Chairman. You asked if there are different kinds of rules, and certainly there are. I think one of the concerns we have is quite obviously any rule is subject to interpretations. There are some rules, however, that do not really bear on the contract market itself. They are administrative in nature or operational, and it seems to us that in many cases they become involved in a very lengthy decisionmaking process.

I would say this, that we submitted a couple of years ago a very, very complex rule that involved the operation of our exchange, and I would like to say at this point that I could not have been any more satisfied than I was with the way that the Commission treated that rule. They worked with us very nicely. We resolved differences. They did everything they could to help us make that rule effective. So in some cases it is not a difficult process.

The thing that we see I think is a problem of inconsistency. Many, many times it seems as though they become involved in things that are not really all that material or important, and it seems to us therefore that if some kind of a mechanism could be developed whereby there could be a time limit and at least an opportunity to be heard at that point, or find out what the real problem is, and that would be very sufficient for our purpose.

Our comments and our testimony, of course, went much more to the contract market designation process, and that is the one, of course, that we felt, and as a matter of fact, devoted a third of our formal testimony, our written testimony to this one matter, and this is the one that we wanted to see improved.

I wonder if I could for just a couple of minutes try my hand at talking about this business of funding, both with respect to the user fee and regulation as a total pie. At the present time, the Commission operates on a budget of about $20 million. We feel confident that the industry, as was mentioned by one of the panelists earlier, spends between $10 and $20 million, and I think we are fairly satisfied with the figure being somewhere around the middle of that, which would be $15 million.

So as of this time, the share of regulation that is publicly funded and therefore presumably beneficial to the public is about 57 percent, whereas the share of the industry's involvement in regulation at $15 million therefore accounts for about 43 percent of a total pie of about $35 million.

Now, let us see first of all what the industry itself is proposing through NFA. The industry is saying, fellows, we are willing to take the $15 million right now, we are willing to add to that if necessary in terms of our own regulatory programs, and by the way, we are also going to kick in another $6 to $8 million—and I will use the figure of $8 million for the sake of my illustration—to add to the burden that the industry is willing to pay for regulation.

Now, what we expect out of that $8 million is some sort of reduction in the function that is performed by the CFTC. After all, this is the premise that the CFTC and the NFA had been working on for a good many years, and I have been involved in that myself.

So let us assume that the industry is willing to spend $8 million and it can see a transfer of just $6 million of function from the Government, from the CFTC. Looking at next year's budget request of $23 million, that would then put the public funding at $17 million and the industry's funding at $23 million, or an approximate reversal of percentage in 1 year over what we see now, wherein the industry would be sharing some 58 percent in the total funding and the Government some 42 percent.

I know that these are a lot of figures, but I think there is a point here that I do want to make. Now we are looking at a $40 million pot for regulation. What the CFTC is proposing, as I understand it, in its proposal is let there be a user fee from which the industry will fund some $15 million of our functions.

Well, what do we have now? We have $15 million of the industry going to fund the Commission, we have another $15 million of the industry doing its own thing, and we have another $8 million going to the pot presumably for the public good because, as a practical matter, most of what the NFA is going to do is going to be done outside of the provinces of the exchange.

So at that point we have a total funding of the industry of some $38 million out of a total of $40 million. You say, therefore, now what does that really mean to the Commission's funding. What it says is this: We have a $23 million budget, of which $15 million is going to be funded by the industry and another $6 million presumably—at least that is all I can assume—off-loaded to the industry, which leaves us the public funding of $2 million, or some 5 percent of the total regulatory pie.

Now, I can come to a couple of conclusions about that. The first question I would raise is is that fair in terms of what regulation does for the industry and the public, for the industry to fund some 95 percent and the public some 5 percent.

I could perhaps even raise another question which would really be if the CFTC is only worth $2 million to the public in terms of a regulatory agency, do we need one at all? I think we think we need one, but most certainly at a tune of 5 percent of the total pot of $40 million, one would wonder just what that really does mean, both to the industry and to the public.

Senator LUGAR. Thank you very much, gentlemen. We appreciate your coming and your patience and your waiting to testify and your forthcoming ability to answer questions.

On behalf of Senator Boren and I, we will adjourn this hearing and look forward to testimony again at 9:30 tomorrow morning.

[Whereupon, at 1 p.m., the subcommittee recessed, to reconvene on Tuesday, March 2, 1982, at 9:30 a.m., in room 324, Russell Senate Office Building.]

COMMODITY FUTURES TRADING COMMISSION REAUTHORIZATION

TUESDAY, MARCH 2, 1981

U.S. SENATE,
SUBCOMMITTEE ON AGRICULTURAL RESEARCH
AND GENERAL LEGISLATION OF THE
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:45 a.m., in room 324, Russell Senate Office Building, Hon. Richard G. Lugar (chairman of the subcommittee) presiding.

Present: Senators Lugar and Helms.

Senator LUGAR. The subcommittee will come to order.

Our first witness today, in our hearing on CFTC reauthorization, is Henry Eschwege, Director, Community and Economic Development Division, General Accounting Office.

Welcome, Mr. Eschwege, and will you introduce your associates who are with you this morning?

STATEMENT OF HENRY ESCHWEGE, DIRECTOR, COMMUNITY AND ECONOMIC DEVELOPMENT DIVISION, GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY LOWELL DODGE, ASSOCIATE DIRECTOR; RALPH LOWRY, SENIOR GAO EVALUATOR; AND JAMES NOEL, ECONOMIST

Mr. ESCHWEGE. Thank you, Mr. Chairman.

On my right is Lowell Dodge, our associate director; to his right is Ralph Lowry, who is the man who was in charge of this review; and next to him is James Noel, our economist, who worked on this review as well.

We welcome the invitation to be here today to discuss our recently completed review of the Commodity Futures Trading Commission.

In recent years, the commodity futures industry has experienced dramatic growth. In the past 5 years, futures volume has nearly tripled, from 37 million contracts to about 100 million contracts annually. The term, commodity, has come to embrace a variety of financial instruments including Government securities and certificates of deposit. Substantial trading in futures contracts for these commodities has developed. The expected proliferation and growth in trading of these instruments, as well as continued growth in agricultural and "natural resources" futures, such as petroleum products, will substantially increase the importance of futures in the national economy.

We have concluded that Federal programs protecting commodity futures customers should be reauthorized. The Commodity Futures Trading Commission, which is responsible for these programs, has made progress in developing a regulatory framework to protect futures markets and customers. The Commission's principal programs, including registration of commodities professionals, market surveillance, review of exchange rule enforcement, and reparations, should be retained and also improved to keep rapidly expanding trading reasonably free from abuse. Even if the futures industry assumes an increasing responsibility for regulation—and we concur in this objective—the Commission will need to continue to monitor the performance of industry self-regulatory bodies.

In reauthorizing the Commission's programs, the Congress should encourage a shift in regulatory responsibilities through amendments to the Commodity Exchange Act. The Commission maintains a program for registering futures professionals. We believe the newly created National Futures Association should assume many of these responsibilities, allowing the Commission to confine itself more strictly to an oversight role in this area.

To assist this transfer, the Congress needs to amend the act to authorize the association to register all futures professionals, including futures commission merchants, commodity trading advisers, commodity pool operators, and floor brokers. It also needs to provide authority to screen them through appropriate fitness checks, including fingerprinting, test them for proficiency in futures trading, and allow professionals to appeal association registration decisions to the Commission.

As self-regulatory organizations, commodity exchanges conduct market surveillance to detect adverse market situations such as price manipulations as they develop and to prevent disruption of the markets. Futures traders' position data presently collected by the Commission is often more detailed than that collected by many exchanges. To increase the ability of exchanges to conduct market surveillance, the Congress should amend the act to allow for the flow of this information to the exchanges on a routine basis.

Extensive reliance on exchange self-regulation to preserve the integrity of markets and to protect the rights of market participants has been a prominent feature of futures regulation since well before the 1974 amendments which created the Commission. We believe the Commission must improve the effectiveness of industry self-regulation as well as its own regulatory programs. Our review has identified a number of essential improvements.

The Commission's rule enforcement review program, its principal tool for monitoring enforcement by the exchanges of their own rules, needs strengthening. The reviews tend to concern themselves with whether essential self-regulatory machinery is in place, rather than how well it is working.

Moreover, the Commission needs to develop improved evaluation criteria, to guide exchange self-regulatory efforts as well as to assist the Commission's assessment of exchange self-regulation.

To promote the efficient functioning of futures markets, the Commission reviews and approves futures contracts before they can be traded. The agency needs to make its criteria for contract approval more explicit and meaningful. For example, the agency should amend its criteria to require exchanges to collect additional economic data to demonstrate that a proposed contract can reasonably be expected to serve a price discovery or risk shifting function. The Commission also needs to adopt procedures which will streamline the approval process.

The Commodity Exchange Act specifies that contracts, once approved, must continue to meet initial approval requirements. The Commission has not given this area sufficient attention. The Commission needs to undertake a systematic review of existing contracts to determine whether they actually provide for price discovery or risk shifting and protect against price manipulation and market congestion.

Moreover, the Commission has yet to tie its approval of trading in proposed contracts at a particular exchange to the results of the rule enforcement reviews it conducts at the exchange, as authorized by the act. Making contract approvals contingent on adequate rule enforcement would encourage the exchanges to enforce their own rules more effectively.

The Commission's contract approval, in effect, licenses an exchange to carry on a business activity. Consequently, the exchanges derive considerable benefits from the approval of proposed contracts. We propose that the Commission assess a one-time fee to defray the appropriate costs of contract approval.

To assure that futures customers are protected in their dealings with commodity professionals and assure a minimum level of competence, the Commission should improve its registration program by requiring the registration of sales and supervisory personnel of commodity trading advisers and commodity pool operators; also, implementing a sponsorship program for associated persons by futures commission merchants; initiating fingerprinting of applicants for registration; by periodically checking the fitness of registrants, and finally, by establishing proficiency testing. The Commission also needs to do a better job of planning for the assumption of registration functions by the National Futures Association.

The Commission has overall responsibility for insuring that commodity customer funds are properly safeguarded. The Commission needs to place greater emphasis on providing additional guidance to exchanges and independent public accountants who are also responsible for auditing industry participants.

The Commission's reparations program—a forum for resolving disputes between commodity customers and industry professionals—is not meeting its objectives. The Commission needs to simplify its rules and procedures. The Commission should also take steps to make arbitration a more attractive and effective alternative to reparations.

A considerable burden can be shifted from the reparations program by removing certain limitations to increased use of arbitration. To increase the potential for use of arbitration, the Congress should raise from $15,000 to $25,000 the dollar limit for claims that customers can compel exchange members or members of the National Futures Association to arbitrate. To resolve the issue of the availability of Federal court litigation, the Congress needs to clarify its intent regarding whether customers have a private right of action to adjudicate commodity-related claims in Federal court.

To keep abreast of a rapidly expanding futures industry and to enhance the effectiveness of its regulatory programs, the Commission needs to improve its use of automatic data processing. This need is greatest in tracking and analyzing the futures positions of large traders to identify possible manipulations, corners, or other situations affecting market integrity.

The Commission needs to give the automatic data processing program overall direction as well as develop agencywide standards to plan and control software development projects. Once needed improvements have been made, the Commission will need to make more effective use of automatic data processing in conducting market surveillance, managing the reparations program and supporting Commission operations generally.

While we propose improvements in a number of key regulatory functions, we believe that these improvements can be achieved largely through a shift of resources rather than through a significant increase in the Commission's budget. Furthermore, many of the actions we recommend, such as improved use of automatic data processing and transfer of selected regulatory functions to industry self-regulatory bodies, offer the potential for substantial long-term savings and streamlining of Commission operations.

In the short run, improved planning and prioritization of Commission activities, as well as appropriate use of fees to recover a portion of the cost of Commission operations, offer additional ways to minimize the impact of needed improvements on the Federal budget.

That concludes my prepared statement. Our specific legislative proposals are attached as an appendix to my statement for your consideration.[1] My colleagues and I will be very happy to respond to any questions you may have.

Mr. **LUGAR**. Thank you very much, Mr. Eschwege. We appreciate also the proposed draft of potential amendments, which will be very helpful to us.

Let me commence the questioning by noting that my colleagues and I have recently read numerous newspaper accounts in which GAO has found the CFTC enforcement procedures inadequate in many, if not most, respects. Could you reconcile these reports with numerous statements in the second chapter of your report, to the effect that, quote, "Building on the substantial progress and achievements realized since its creation nearly 7 years ago, we believe the Commission can continue to review and refine its regulatory role."

In short—and I have in front of me the "Wall Street Journal" February 19, 1982, which says, "CFTC's review of futures trading rules is inadequate," watchdog, unit charges.

Can you give us some overview of what you have really found, so that we can put this in perspective?

Mr. **ESCHWEGE**. Yes, and I think it is very important that we put it in perspective. We have been making periodic reviews of the CFTC, as well as its predecessor, while it was still lodged in the Department of Agriculture. And of course, anything we say is relative to what we found previously, and in that context, we have said that there has been marked improvement. We have a long way to go, but we see that the Commodity Futures Trading Commission is trying to focus on the major problems, and in our draft report, we point out several weaknesses which the Commodity Futures Trading Commission is working on to try and correct. You have seen the statement made by the Chairman, who is fairly new at the Commission; we have talked to him. And we feel, at this time, at least, fairly confident that he will adopt many of our recommendations, and also seek the kind of legislation, in some respects, that we are asking for, in order to tighten up the whole agency's regulatory process.

---

[1] See p. 446 for the legislative proposals of Mr. Eschwege.

Senator **Lugar**. Indeed, as you have perhaps read, in the course of the Chairman's testimony, he acknowledged a good number of comments and attempted to address those, and either the Commission feels that it is meeting some of the criticisms, or it would plan to try to do that in legislation. Your contribution in that respect is very timely, because it occurs to me there is a disposition on the part of the Commission members to accept the findings that you have and to act upon them.

Now, one of the general findings or suggestions of your report may be that the CFTC is understaffed. For example, I find language to the effect that the CFTC would be hard-pressed to reconcile a strong regulatory mandate with the exigencies of budget austerity.

Is this your general feeling? In other words, is the mandate, the number of contracts that are new, the extension of the entire futures industry such that in your judgment, the CFTC simply does not have enough people, or enough people of the right talents? How would you characterize the finding in that respect?

Mr. **Eschwege**. I would characterize it more as a situation where they do not have the people in the right places. They are focusing too much on activities which hopefully can be turned over to, let us say, the new National Futures Association, as well as some that can be turned over to the exchanges. They could then use the freed resources to pay more attention to oversight rather than the actual auditing of futures commission merchants or the registration function—they could focus on being primarily a monitor of the exchanges and the NFA and the market itself.

Therefore, we have said that we do not really foresee any appreciable increases in their staff. They have asked for a modest increase in the 1983 budget; I believe it amounts to about 40 additional people.

Senator **Lugar**. You recommend that a fee be charged to exchanges to process the designation of new futures contracts. Do you have any recommendation on the size of the fee or the factors on which it should be based?

Mr. **Eschwege**. Mr. Noel might answer that.

Mr. **Noel**. Well, Senator, we did look at the budget. About $800,000 to $900,000 is devoted to this activity every year, and it would be necessary to reduce that figure by a certain amount to allow for the benefits that flow to the public from designation of new contracts, and then to allocate that over the 20 or 30 applications that are received every year. So you are talking about a not inconsequential fee, but not really a substantial fee, given the economic value of these contracts.

Mr. **Eschwege**. What we are saying here is that it would not bring in as much in the way of funds as the transaction fees, for instance, that are being proposed by the Commission.

We are suggesting the possibility of some other fees, but they would also be minor, for example, in return for collecting and providing certain data to the exchanges.

Senator **Lugar**. Now, let me ask your general judgment on this transaction fee question. This has understandably occupied several hours of the hearings to date, with sharply divergent views on this subject. One of the panelists yesterday from the industry suggested that our overall problem was one of trying to determine how much regulation is required, how large this market is or its potential for growth and who ought to be doing the regulating. What proportion of that cost should be borne by the users or participants in the market as opposed to the public interest.

A moment ago, in response to the smaller question, the problem was addressed of so much public interest as opposed to so much private, which is precisely the same question in a different form. If you were to try to assign relative strengths to these proportions, how should we most appropriately address this, from your professional experience?

Mr. **Eschwege**. Well, I do need to say to you first that we have really not studied this transaction fee proposal. It was not one of our proposals. We have been involved in other reviews of fee structures, such as with the Federal Communications Commission. You may recall several years ago, there was a court case in which certain parties took the FCC to court and claimed that the fee that was being charged was too large because it included a cost for protecting the public, and as a result the FCC had to refund some money to these people.

I am not a lawyer, but my understanding is that the Congress could, of course, decide to make the exchanges or the customers bear the full brunt of the fee if they so chose to write the legislation.

I cannot comment directly on the transaction fee, but there is bound to be in any regulation of this sort a public interest facet. It is very difficult to weed that out and say so much is attributable to the public good and so much to the benefit of the individuals and the exchanges that are trading.

Senator **Lugar**. Indeed, it is difficult, but this is the reason that I pose the question to you and the others who have some Government experience, because at some point I think we probably are going to have to make this kind of decision, in the subcommittee and then in the committee and maybe in the Congress. Up to this point the industry is arguing that it is already paying for regulation, and we are going to try to gather these figures, but as much as $15 million was suggested in testimony yesterday as the amount of the exchanges' self-regulation, and maybe as much as $8 million, the contributions for the new NFA idea. Now, if so, the thought, at least that came through in that arithmetic, was that $23 million might be devoted by the industry, and the budget, coincidentally, of the Commission for the next year will be about $23 million. So that the thought was that conceivably, this was sort of a 50/50 proposition.

Now, in the dialog yesterday, some suggested that in fact, it should be more like one-third public and two-thirds industry. The industry was suggesting that maybe the NFA and that contribution, plus the self-regulation, did about as much as they ought to be doing, and that therefore, we would not need a user fee, a transaction tax, things of that variety, if we came to that conclusion. Could you comment on this?

Mr. Eschwege. Well, it is a very difficult question. The only fees that we are proposing are of a different nature. They would actually be assessed in cases where there is obviously a benefit to the exchange such as when they come in and ask for contract approval.

In my experience, I have not found a good way of breaking down the different costs. But we have suggested to the CFTC that they need to think about some criteria that they want to assert so that people can comment on it. The end result would be to determine what part of cost is really in the public interest.

Senator Lugar. So your advice would be that CFTC will have to articulate very clearly the nature of transaction fees, with the rationale for doing this.

Mr. Eschwege. Yes, if that is the way the Congress wants them to go. My understanding, though, is that the Congress could simply decide that the CFTC's entire costs should be reimbursed, and if it is written in the legislation, then the Commission would not have to worry about that.

Senator Lugar. Now, you have made a number of recommendations in your report on registration, including fingerprinting, sponsorship of applicants, registration of sales, supervisory personnel, development of plans for NFA functions, the registration functions. Do you know to what extent the Commission has already moved on any of these registration plans or issues?

Mr. Eschwege. Mr. Lowry?

Mr. Lowry. Senator Lugar, the Commission has made a number of legislative proposals which accomplish, or are designed to accomplish, most of the things we discuss in our report. As you know, the Commission was given legislative authority in 1978 to require fingerprinting of applicants for registration. We found that because of problems with ADP support and their ability to accommodate the additional information that would be generated by the fingerprinting requirements, they were not able to implement fingerprinting in the 4 years which intervened.

They are taking steps now, and it appears that they will be able to go ahead with AP sponsorship and fingerprinting by July of this year, and we would certainly support them in that effort.

Senator Lugar. The criticism by GAO of the enforcement reviews received considerable attention in the press, and in particular, the lack of followup on rule reviews, and the reviews of the two largest exchanges are several years old, I think you noted.

Now, in contrast, the CFTC Chairman said that GAO's findings are mainly retrospective, that within the next 2 or 3 weeks, the CFTC will complete its rule enforcement reviews of the Chicago Board of Trade and the Chicago Mercantile Exchange. Can you comment on your findings in light of Chairman Johnson's statements, or throw any further light on that?

Mr. **Eschwege**. I appreciate his statement. What we found with respect to those two exchanges, the Chicago Board of Trade and the Chicago Mercantile Exchange, was that the reviews actually had been started, respectively, in August and November of 1980, and here we are, more than a year later, and we still have not seen the final reports, although we understand that drafts have been available for several months. I appreciate his comment that the report will come out soon. These two exchanges transact more than 75 percent of all the commodity futures trading, and we felt it was very important that the public and everyone, the Congress as well, get a look at the final results of these reviews.

Our general assessment of the rule enforcement area is that the Commodity Futures Trading Commission has not done the job that we feel it ought to do in reviewing how well the exchanges are regulating themselves. They have found some weaknesses; however, they have not followed up on them as promptly and thoroughly as we believe they should. They sometimes follow up on them when they go in again a few years later, but even at that point in time, they do not necessarily look at whether the weaknesses in specific areas have been corrected.

We hope that the rule enforcement review activity can improve, because we do see a further role for the exchanges to regulate themselves; but so far, the evidence that is available indicates that the exchanges have quite a way to go before they can be relied upon fully to regulate themselves.

Senator **Lugar**. In the draft bill that has been presented to this subcommittee as a basis for our hearings, the CFTC has proposed changes which make the arbitration process more attractive, as opposed to CFTC's operations. To what extent do the changes that the CFTC has proposed in this legislation meet the recommendations of your office?

Mr. **Eschwege**. I think they are very similar, and we endorse pretty much what the Chairman is proposing about arbitration. We have suggested that the limit be increased from $15,000 to $25,000 for transactions that can be arbitrated either on the exchanges or with the NFA. That would take in probably about 80 percent of the trading that goes on or the cases that they have. There is a slight difference in that the Commodity Futures Trading Commission in its proposal wants to leave open the upper limit. They do not want to limit it to $25,000. We thought there ought to be some limit, but it is not a very material difference.

Senator **Lugar**. Could you comment on the National Futures Association recommendation that the Commission's reparation program be abolished when the NFA's national system of arbitration becomes operative?

Mr. **Lowry**. Senator, I think that it would be premature to make that final determination with regard to the Commission's reparation program. Clearly, we feel the program could operate more effectively. I think there is general agreement on that at the Commission as well.

The Commission is proposing legislative proposals that would improve the operation, or at least are designed to improve the operation of the reparations program by making it somewhat like an arbitration program. They are calling for increased administrative flexibility. They are calling for changes that would exclude from reparations claims against people who are not registered with the Commission.

In general, we would support this, but with a proviso that an alternative forum that does provide full due process be available for those who feel that they want and need, not the increased flexibility that arbitration provides, but the increased due process which is available in a judicial forum.

Senator LUGAR. Gentlemen, we thank you very much for your testimony today and for your comprehensive study. It is timely and most helpful. This is an important period in the oversight function of this subcommittee and indeed, in the Congress. We will be pouring over your pages, and perhaps be back and forth with you, if we may, if the members have additional questions beyond the ones that I have asked this morning.

Mr. ESCHWEGE. Thank you. We appreciate the opportunity to be here.

Senator LUGAR. The Chair would note this, in terms of the general format of the hearing at this point. At 11:30, rollcall votes will commence on the floor of the Senate. There will be a number of them, and that will disrupt the hearing probably fatally, as far as the rest of the morning is concerned. So, for that reason, I am going to ask the sergeant-at-arms of the committee to adopt a over 5-minute rule. That will mean that each witness will have 5 minutes—we will not be absolutely rigorous about that. There may be some questions so that we may amplify the time. But in that way, we want to make sure each of our six witnesses is heard.

We will proceed now with Neal Gillen; vice president and general counsel of the American Cotton Shippers Association.

Good morning, Mr. Gillen.

STATEMENT OF NEAL P. GILLEN, VICE PRESIDENT AND GENERAL COUNSEL, AMERICAN COTTON SHIPPERS ASSOCIATION

Mr. GILLEN. Good morning, Mr. Chairman.

I am Neal P. Gillen of Washington, D.C., vice president and general counsel of the American Cotton Shippers Association. We appreciate this opportunity to assist the Congress by providing our views of the Commission's operations during its brief history.

The ACSA supports the reauthorization of the Commodity Futures Trading Commission as an independent regulatory agency for an additional fixed number of years.

Our members utilize the futures market to hedge crop purchases and sales to domestic and foreign mills. The futures market therefore is a necessary and vital adjunct to our business operations. The sound regulation of futures markets is in the best interest of our members and our farm and textile mill customers.

In 1974, we recommended to the Congress that the regulation of commodity futures trading be removed from the Commodity Exchange Authority in the Department of Agriculture and established in an independent agency. Few people shared that point of view. In fact, the witness for the Department of Agriculture opposed the establishment of an independent regulatory agency suggesting that regulation continue in the Department. The public hue and cry for reform in 1974, together with investigations by the GAO and the Congress, documented a case of regulatory inactivity on the part of the USDA. Even if the USDA had the appropriate tools to effectively police the growth in commodity futures trading, it lacked the disposition to put them to adequate use. The subsequent expansion in the nonagricultural contracts and the overall dramatic increase in futures trading justifies the establishment of the Commodity Futures Trading Commission.

In 1978, the Commission was criticized for shortcomings in its structure and functional operations, problems not associated with the substantive body of the 1974 act. Again we supported the Commission recommending reauthorization. We believed then that a fair and impartial review would conclude that the matters for which the Commission was then criticized were attributable to questions of leadership, expertise, and proper direction. That review concluded that, in its real and primary function as an economic regulator of futures trading, the Commission performed exceptionally well in developing sound regulations including a new definition of hedging, a new aggregation policy, the phasing out of daily trading limits and a comprehensive review of speculative limits. In supporting the reauthorization we did, however, oppose attempts to include within the Commission's jurisdiction the export reporting authority of USDA and the regulation of forward contracting of agricultural commodities.

In our 1978 testimony, we stated that "the Commission is moving in the proper direction, the direction pointed to by Congress in 1974." While the Commission made great strides in the last 7 years, the enforcement role originally envisioned by Congress has given way to an administrative bureaucracy preoccupied with functions best performed by the exchanges or the National Futures Association, a self-regulatory organization. It is our belief that this trend can only be rectified by changes in the act.

Legislative modifications are necessary to redirect the Commission back to its originally conceived role of surveillance and enforcement. The exchanges, not the Commission, should have exclusive authority to designate delivery points, determine the qualities to be traded, establish differentials, and to set margins and other contract terms. Reestablishing this discretion solely in the hands of the authorized exchanges will allow the markets to function freely and the Commission to concentrate its limited resources on enforcement.

Our recent experiences evince a disposition on the part of the Commission to inject itself into the marketplace to protect users of the cotton contract from their own bad judgment. Too much of the Commission's and the industry's time has been expended considering baseless theories and allegations of individuals or firms whose judgment was flawed in purchasing and selling or failing to do either in the spot and/or futures markets. As a result, an effective and useful contract has often been attacked by those who missed the market. The mistaken theory utilized in these instances is, "I was not wrong; the contract must be wrong—therefore, I will have the contract changed."

The Commission's role in the New York Cotton Exchanges' No. 2 cotton contract and the Chicago Board of Trade's proposed medium staple cotton contract are cases in point. In each instance, the Commission staff suggested changes in the contract, unjustified changes, that we believe would result in each contract being unsuitable for hedging and inadequate for price discovery. The association's comments and analysis submitted to the Commission in September on the proposed contract market rules of the Board of Trade's cotton contract, outline in great detail how the Commission has substantially detoured from its enforcement role and has mired itself, the exchanges, and the commercial hedgers in a regulatory morass. This document is attached as part of our testimony of record, and we request that it be included.[1]

Senator **Lugar**. It will be included.

Mr. **Gillen**. Unlike other Government services funded by user fees, such as cotton and tobacco classification or grain inspection, the potential benefits of commodity futures regulation extend substantially beyond those directly affected.

Futures markets obviously benefit those engaged in actual trades, but others who benefit are numerous. The open and competitive price discovery function of futures markets benefits the general public providing more stable prices through the convergence of conflicting price expectations in a public exchange. Marketing costs and the prices paid by consumers are reduced by the shifting of price risks. The contributions of futures markets to the country's economic well-being and stability do not justify directly placing the cost of regulation upon those who trade. The markets are public, the public benefits, the public demanded broader regulation, and the public should share the costs. To do otherwise would be totally inconsistent with this broad distribution of benefits.

In true perspective, what has been suggested is not a user fee, but a transaction tax to be unjustly borne by commercial hedgers and speculators. The futures markets could not exist without the trading activity of commercial hedgers, who seek to reduce their risks by utilizing futures to lock in protection against swings in the prices of physical commodities, and speculators who provide the liquidity necessary to the effective functioning of the market. The involvement of both is essential; otherwise there would not be a market.

A transaction tax on commercials and speculators places a disproportionate burden on the shoulders of those the least enamored with the regulatory process and those less in need of the Commission's protection. Also keep in mind that most of the questionable practices originate in commodity schemes not transacted on regulated exchanges and therefore not subject to a transaction tax. Why should commercial hedgers bear the direct burden of policing the various schemes conceived in so-called boiler room operations? This is just as repugnant as having to pay for the administrative excesses referred to earlier in my testimony.

The user fee proposal is misconceived and has no place in commodity transactions. Admittedly, the concept is workable in other areas, but in this instance, the budget for the Commodity Futures Trading Commission should be financed by general revenues.

---

[1] See p. 449 for the document referred to by Mr. Gillen.

In conclusion, the CFTC should be reauthorized for a period not to exceed 5 years in order to provide some continuity in the oversight role of the Congress. Reauthorization beyond a term of 5 years would preclude the Congress from exercising effective oversight of an agency it had created, and could result, through turnover in the Congress, in reauthorization hearings before congressional committees unfamilar with the agency.

The functions of approving new contracts and contract market rules are best performed by the exchanges. When an exchange has been approved by the Commission, it should then have the right to trade a commodity without being subject to the lengthy and unnecessary process of justifying to the Commission the economic utility of a contrac The market not the Commission can and should make these decisions.

If the contract does not trade, it will have failed the test—it will have lacked an economic purpose. Why waste the limited resources of the Commission on time-consuming functions best performed by the market?

We also wish to oppose the granting to the Commission the authority to establish margins for agricultural commodities, we insist that the exchanges retain their right of judicial review whenever the Commission makes use of its emergency powers, and we wholeheartedly endorse the self-regulatory program and plan of the NFA.

Thank you, Mr. Chairman, and if you or members of the subcommittee have any questions, I will be happy to respond.

Senator **Lugar**. Thank you very much for your testimony.

You have addressed the user fee proposal and indicated that the concept has worked in other areas, but in this instance, the budget for the CFTC should be financed by general revenues.

You have perhaps heard the previous testimony, and we have been trying to weigh what is the public interest and the public value in the CFTC, as opposed to the private value and the values that come principally through traders.

How do you come down on this? One way of demarcation is, I suppose, as you suggest in your testimony, that the budget of $23 million for CFTC come from general revenues, as it does presently for the $20-million figure. But theoretically, why shouldn't a portion of this be paid for by user fees—if, for example, the OMB or the Congress were attempting to minimize the cost to the Federal Government?

Granted, the premise that you have in your testimony, is there a prohibition that you see in terms of thinking in terms of transaction tax, if you are simply looking for revenues, as a way of paying for Government functions?

Mr. **Gillen**. The record is clear in the area of the new financial futures. People from the Fed and the Treasury have testified before other committees in the Congress, that the futures market has proven to be of great value as a stabilizer. The public benefits in many areas. I am best-suited to address the agricultural commodities, particularly cotton, but I am generally familiar with some of the other commodities. Were all commercial users to make proper use in hedging their fixed purchases and sales, they could, one, build in profits in their acquisition of their raw materials, and two, would not have to continually pass on added costs to the consumer. We are experiencing a situation in the economy where, for the past 10 years, the consumer has been unjustly bearing the burden of inflation, and now, industry is bearing that burden, and they are trying to rectify it by cutting down their prices, making less products available but of better quality, and the consumer is sitting back and waiting.

I have digressed somewhat from your original question. Just because OMB recommends something, I do not think it has been fully thought through. In some instance, there are specific benefits, directly related to services. GAO touched upon those; the designation process, for one, that is identifiable. It is time-consuming and expensive. That can be addressed. Some of the fingerprinting, the certification of FCM's, these administrative details which the NFA would like to and, I think, should take over, can substantially reduce the budget. The NFA figures are one-third of budget—157 people, I believe, and some $7 million. So that is a substantial decrease.

The user fee transaction has just been suddenly thrust upon us. We have not been privy to the thinkings of those at OMB, and some might opine that that thinking has been flawed at times—at least, there have been articles to that effect.

So in summary, I would say that the public benefits substantially through the vehicle of futures markets, and the public is demanding regulation. There are other committees in the Congress stressing this fact, and the public should bear the cost, and it is a relatively insignificant cost.

Senator **LUGAR**. Let me just ask this question. One of the best ways of avoiding market manipulation by foreigners, and the specification of contract terms, which conform to commercial practice, and assure an adequate and deliverable supply, from your statement, I would understand you do not believe the Government has an oversight role in this important function. Would you comment on that?

Mr. **GILLEN**. I believe they do have an oversight role, but it is a minimal oversight role, and I think that role should begin in the certification of exchanges. Once an exchange has been deemed to be a legitimate body that has a sound set of operational rules, has a board of governors or directors, which is a composite of commercials, floor brokers, the commission houses and the public, equally weighted, with proper surveillance of the trading by the exchanges, I think the role of Government is not necessary. Prior to 1974, with the nonagricultural commodities, this was the case. It worked well in most instances. There were some abuses in some smaller exchanges. I admit, it is a two-edged sword. My problem is specifically related to the cotton contract, where you have the situation where people who made substantial mistakes in the market—mistakes in judgment—then came to individual members of the Commission, or all of the members of the Commission, and exerted political pressure on the Commission. The Commissioners in turn relayed this to the staff, and the staff, I think, put undue influence on two exchanges that I am familiar with. This should not be the case.

The commercials out in the public market monitor the contracts. If there are not enough delivery points, or too many delivery points, the utilization of the contract will dictate changes. It is not up to staff people, working for the Government, to determine what should or should not be traded and how it should be traded. Insofar as differentials for various qualities, tendering at various locations, this too is something that the commercials determine by their use of the contract.

Senator LUGAR. Thank you very much for coming this morning, for your testimony, and for being so forthcoming in your answers.

Mr. GILLEN. I appreciate the opportunity.

Senator LUGAR. The Chair will now call on Daniel Amstutz, the chairman of the Commodity Exchange Committee of the National Grain and Feed Association.

Welcome. Will you please proceed.

STATEMENT OF DANIEL G. AMSTUTZ, CHAIRMAN, COMMODITY EXCHANGE COMMITTEE, NATIONAL GRAIN AND FEED ASSOCIATION, AND GENERAL PARTNER, GOLDMAN, SACHS & CO., NEW YORK, N.Y.

Mr. AMSTUTZ. Thank you, Mr. Chairman.

My name is Daniel G. Amstutz. I am a general partner of Goldman, Sachs & Company of New York. I am chairman of the Commodity Exchanqe Committee of the National Grain and Feed Association, on whose behalf I appear here today.[1]

We believe that all futures markets should be regulated by an independent regulatory body. We basically concur with the agreement between the CFTC and the SEC regarding the division of regulatory authority over options markets whereby the CFTC would have exclusive jurisdiction over all permissible futures contracts as well as options on those futures contracts, and would regulate options directly on foreign currencies traded on commodity markets. We would, however, disagree with any veto power being granted to the SEC or any other Federal agency in any area where the CFTC has exclusive jurisdiction.

We are concerned about proposals that call for margin authority to be vested in one or more Government agencies. We believe margins on futures contracts should continue to come under the purview of the individual futures markets. We do not believe any Government agency, no matter how enlightened or well-intentioned, possesses the capability to manage the margin responsibilities for futures markets. In our judgment, only the individual exchanges have the capability to deal with the logistical realities of margin-setting responsibilities, regardless of the underlying commodity. It makes no difference whether the commodity is a traditional one such as wheat, or a new one, such as a price index on equity securities.

We have several comments to make regarding user fees. We do not believe that any Federal agency should be granted authority to directly tax those it regulates. We are firmly convinced that any system of user fees adopted by the Congress should contain the proviso that all revenues resulting therefrom flow to the U.S. Treasury and that any and all agencies that are financed from these revenues continue to follow the procedure of requesting appropriations from the Congress as a means of annual budgetary control and oversight.

---

[1] See p. 490 for the prepared statement of Mr. Amstutz.

We think it is an uncontested fact that the price discovery process of futures markets provides significant value to all segments of the Nation's economy. The Congress should recognize this when determining what portion of the CFTC's operating expenses should be borne by general revenues and what portion should be covered by specific, narrowly focused user fees. In our judgment, it would be inequitable and an injustice if the Congress would determine that anywhere near all the revenues necessary to cover the CFTC expenses should come from user fees. And, Mr. Chairman, let me add that we would suggest that at least 50 percent come from the general revenues.

A very substantial portion of the CFTC's expenditures; are devoted to: (a) The process of examining and approving new contract proposals; (b) investigating and/or overseeing activities of commodity pool operators and commodity trading advisors; and (c) matters pertaining to those futures commission merchants who are not members of contract markets. Implementation of a realistic fee structure to cover those high-cost areas for the CFTC, assessed as fees for new contract approvals, and registration and auditing fees for CPO's, CTA's, and FCM's would, we think, provide the means for collecting needed revenues. We believe that any cost/benefits analysis would endorse our view that a user fee structure that focuses on those categories of users or uses of CFTC services, those which create the operating expenses for the CFTC, is the most equitable manner in which to levy such taxes.

We are opposed to a user fee approach based on transaction fees. The preponderance of such transaction fee taxes would be levied on those who provide market liquidity, commercial hedgers and independent traders, yet these are not the entities that create the expense load for the CFTC. Constraints resulting from transaction fee taxes could restrain the trading activity of those who are, in a very real sense, the market makers. Transaction fee taxes would thus adversely affect all-important market liquidity.

Any user fee approach adopted by the Congress should recognize that the CFTC's need for revenues should diminish as the National Futures Association becomes operational. A substantial portion of the NFA revenues will be collected via user fees, particularly from small traders and small business hedgers. The Congress should be wary of the possibility of dual user fees for duplicative regulatory functions being assessed on market users. In order to guard against this and to help insure that an equitable user fee concept is adopted, our association recommends that an advisory committee be authorized to make recommendations to the CFTC on this important issue.

From time to time it appears that some conclude that the regulation of cash commodity forward-contracting should be undertaken by the Federal Government. The National Grain and Feed Association strongly recommends that no added provisions for the regulation of cash commodity forward-contracting be included in the extension of this legislation.

At the present, it is not lawful for options trading to be conducted in the United States on those agricultural commodities which were regulated by the predecessor of the CFTC, the Commodity Exchange Authority.

We welcome the initiation of the CFTC-regulated pilot program on options. Concurrent with the functioning of that program, the National Grain and Feed Association will be studying the feasibility of options trading on grains and oilseeds. Subject to the success of the pilot program on permissible commodities and subject to positive findings of our own task force, we may eventually recommend that legislation be enacted to permit trading in options on grains, oilseeds, and oilseed products. At this particular time, however, we believe it would not be appropriate to introduce such legislation.

We recommend that the Commodity Exchange Act, as amended, be extended for a period of 4 years.

The National Grain and Feed Association desires to be helpful to the Congress as it considers this reauthorization legislation. We hope, Mr. Chairman, that you will contact us with any questions whatsoever.

Senator LUGAR. Thank you very much for your testimony this morning. It is concise, direct, and understandable.

I would raise this question. The CFTC in its proposal for the transaction tax retains the authority to waive all user fees if they determine this to have an adverse impact on the market. Do you feel that this provision provides adequate protection of the concerns expressed in your testimony?

Mr. AMSTUTZ. No, Mr. Chairman, and I believe that can be cited as one reason we recommend an advisory committee approach. We are well aware that there is a good deal of skepticism about advisory committees, but we think in this particular instance, that it is advisable.

Senator LUGAR. What would the advisory committee do, or what do you envision its responsibilities might be?

Mr. AMSTUTZ. Well, I think, of course, subject to the authority that is being granted the CFTC by the Congress, that the advisory committee could certainly be helpful in pinpointing areas of user fees based on services provided by the CFTC, and in helping the CFTC determine truly what its costs are for new contract approvals, what its costs are for commodity trading advisor and commodity pool operator supervision.

Senator LUGAR. So you would followthrough with the GAO testimony this morning, in which they recommended certain fees for specific services—I think you cited that in your testimony.

Mr. AMSTUTZ. Yes.

Senator LUGAR. But you feel an advisory committee would be required in order to try to put a dollar figure on those services. In other words, at this point, it would be an arbitrary judgment as to how much it costs to verify the validity of a new contract, or to fingerprint persons, or this sort of thing?

Mr. AMSTUTZ. Exactly, Senator, and I believe—and I believe that if the chairman of the CFTC were here today, he would state—that one of the reasons the CFTC recommended a transaction fee was that it was simple. And I understand the desire for simplicity in any program of taxation, and that when we are recommending charges for specific services, that there is a certain amount of empirical analysis that has to go into the question of determining what the value of those services is, but I believe that an industrywide committee could help the CFTC in arriving at those reasonable and realistic fee levels.

Senator LUGAR. Thank you very much for coming this morning. I appreciate it.

The Chair would like to call now Mr. Stuart Proctor, assistant director of the National Affairs Division of the American Farm Bureau Federation.

Welcome, Mr. Proctor.

Would you proceed with your testimony?

STATEMENT OF STUART PROCTOR, ASSISTANT DIRECTOR, NATIONAL AFFAIRS DIVISION, AMERICAN FARM BUREAU FEDERATION

Mr. PROCTOR. Yes, thank you, Senator.

Good morning. My name is Stuart Proctor. I am assistant director of the National Affairs Division of the American Farm Bureau Federation.

The Farm Bureau appreciates the opportunity to present our testimony this morning on proposals to revise and extend the regulatory authority of the CFTC.

In the interest of time, I would like to summarize my comments and request that a copy of my statement be included in the record.[1]

Senator LUGAR. It will be included.

Mr. PROCTOR. Thank you.

We recommend approval of legislation to extend CFTC. One of the most controversial issues that will be faced during these hearings is that of user fees. In the past, the Farm Bureau has supported the user fee concept. We believe that those who benefit from Government services should be required to pay the regulatory cost.

However, we are hesitant to support the CFTC user fee for two reasons. First of all, we think that it asks that the user pay an unusually heavy burden of the regulatory cost, because it does not recognize that others in the marketing chain—consumers, farmers who are not using the CFTC—also benefit from the regulatory function performed by the CFTC.

We will support a user fee concept in which the user pays only for the benefits which he receives.

The second point, we are reluctant to support the CFTC proposal because there has not been an analysis or an evaluation of the effect on speculative trading and the effect on the liquidity of the market.

---

[1] See p. 495 for the prepared statement of Mr. Proctor.

Another important issue during these hearings will be options trading. The board of directors of the American Farm Bureau will meet next week and take up a proposal on options trading. I would like to ask that our comments be revised to include the recommendation of the board after they meet next week.[1]

Senator LUGAR. We will appreciate receiving those, and we will include those in the record.

Mr. PROCTOR. Thank you. The Farm Bureau will oppose any effort to grant CFTC the authority to directly regulate speculative limits. We feel that the current system, which allows the exchanges to set the limits and grants CFTC oversight responsibility is the type of regulation that we would be in favor of.

One other comment that we have. The percent of agricultural contracts traded currently represents about 50 percent of the total volume of all commodities traded. We think that this indicates the need to have at least one of the Commissioners of the CFTC who is familiar with agricultural affairs. We would like to see this committee indicate its desire to have at least one of the Commissioners familiar with agriculture. We would like to see that desire expressed as part of the committee report.

That is a summary of our comments, and I would be glad to answer any questions.

Senator LUGAR. Thank you very much, Mr. Proctor.

As you know, the Farm Bureau has testified, I think, in this respect before. The committee shares your enthusiasm for having an agriculture-oriented member on the Commission, and the members of the committee have expressed this concern to the President. Hopefully, that was a part of the reason for a recent nomination. As I understand your testimony, you are hopeful that in the report coming from the committee with regard to reauthorization, this general principle might be included?

Mr. PROCTOR. Yes, sir. We would like to see it as part of the legislative history. We commend the committee for their action and the fact that we do now have one of the Commissioners who is familiar with agriculture. We think we could avoid a lot of that effort in the future if it was incorporated as part of the committee report. We are reluctant to set up quotas or dictate that a certain number of the committee members be familiar with agriculture, and therefore, that is why we recommend that it be as a part of the report.

Senator LUGAR. I understand.

Essentially, the burden of your testimony on the fee schedule idea is one of trying to find a direct relationship between the fee and the benefit, and essentially, you also add that an analysis of the impact of this structure on speculative trading and market liquidity is of the essence.

What would be an appropriate way of discovering these facts of relationship or of market liquidity? Are you suggesting, as one witness has before, an advisory committee, or should this committee detail that this subcommittee or others make such discovery? Or, can you offer any ways in which the general thrust of your testimony might be realized?

---

[1] See p. 495 for the recommendations attached to the prepared statement of Mr. Proctor.

Mr. **Proctor**. Well, perhaps the CFTC could establish a study committee to look into the issue—take the fee schedule that they have outlined, the 6-cent-per-transaction user fee that they have proposed, get an idea of what that means to the speculator in terms of his aftertax cost. An estimate of cost and profitability and trade must be made by the CFTC. That would be one way. Then, perhaps another way would be to make the changes necessary to allow options trading in domestic agricultural products.

Senator **Lugar**. Yesterday, we had testimony from industry leaders, exchange officers, and what-have-you. Their testimony was that the 6-cent or the 12-cent roundtrip fees would inhibit substantially the speculators. I suppose, if we were to conduct a study, we would go about it almost the same way we are in this subcommittee. We would ask people what their general supposition is from their experience; how one can conduct a study that tries to get to the heart of this liquidity problem and the price discovery problem, is hard to tell, which is why I was asking the question of each of our expert witnesses, because there are impacts here, they are serious, and this committee has to try to gage these so that we do not make irresponsible public policy decisions, even while we are attempting to determine who ought to pay and what the extent of the regulation ought to be and what the public interest is. So that is the burden of my question. You are suggesting that maybe the CFTC itself, through its expertise, or by commissioning certain persons to do this, would be the appropriate place to do that.

Mr. **Proctor**. Yes, sir. And I guess we are a little surprised that that was not done before the proposal came forward. And we are a little bit surprised that that was not included as part of the criteria to come up with the 6-cent transaction fee.

So, yes, as a starting place, we would like to see a CFTC analysis. If, in fact, there is evidence it will have an effect on speculative trading, then we would be opposed to the user fee concept.

Senator **Lugar**. I appreciate very much your coming, and we will look forward to the additional recommendations of your board after its meetings in the next week or so.

Mr. **Proctor**. Thank you. It is a pleasure to be here.

Senator **Lugar**. The Chair would now like to call Jack Barbanel, general counsel, Commodities Corporation, Princeton, N.J.

Good morning. It is good to have you here. Please proceed with your testimony.

STATEMENT OF JACK A. BARBANEL, GENERAL COUNSEL, COMMODITIES CORPORATION, PRINCETON, N.J.

Mr. **Barbanel**. Thank you, Mr. Chairman.

I am going to attempt to meet the committee's schedule on a timely basis, so I have attempted to redact a portion of my presentation to meet the time restraints here.[1]

Before I begin, permit me to express my gratitude for the opportunity to testify before this subcommittee during such a crucial period for the CFTC and the futures industry.

---

[1] See p. 498 for the prepared statement of Mr. Barbanel.

I am a vice president and general counsel of Commodities Corporation, a privately held company that trades futures, forwards, physicals, and to a lesser extent, securities for its own account, serves as a consultant to other users of the futures markets, and through its wholly owned subsidiary, manages, as trading advisor, approximately $40 million of publicly offered commodity pools' funds. The company is a registered commodity pool operator, trading adviser, and is also a member of major commodity exchanges.

I will address three areas of concern in connection with the pending reauthorization of the CFTC: one, speculative limits; two, user fees; and three, State jurisdiction as it affects commodity pools.

On the first point, Mr. Chairman, the CFTC in its proposal to establish speculative limits on all traded contracts has a stated objective to prevent excessive speculation which in turn may cause unreasonable fluctuations or unwarranted changes in supply and prices of a particular commodity. Otherwise stated, the CFTC is attempting to prevent prices which are not reflected in the real world of supply and demand.

I believe that the speculative-limit rule recently proposed and promulgated is nothing more than a knee-jerk reaction to the recent, so-called manipulation and squeeze of the silver market. The rule, by its own terms, appears to imply that the CFTC is incapable of properly monitoring and rationally regulating the marketplace, and therefore, it should impose such constraints that in effect would relieve the agency from its monitoring responsibility.

An analagous example can be made to the current gun control debate, that is, let us take away all the guns, and no one will commit crimes. However, we all know that people commit crimes, and not guns. This logic can be equally applied to the issue at hand. No limits, or rational limits, do not in and of themselves cause squeezes or manipulative prices; it is the individual behind them. We must recognize that the size of a position or the affecting impact per se do not legitimize the position, but rather, the motivational forces behind the accumulation of the position or the sought-after effect. Intent to manipulate, and to so act as to accomplish the manipulative goal is what should be scrutinized. Why, then, punish the ethical and well-intended market participants, which comprise the vast majority of the market users, for the misdeeds of the unscrupulous? Is it not enough for the CFTC and the exchanges to monitor large trader reports, which clearly disclose the positions owned by a particular account. As an example, let us take a look at the equity market. As an investor, I am not restricted from accumulating a substantial position in IBM shares provided, however, that I have complied with certain SEC filing requirements when reaching a designated percentage of the total float. However, I am not absolutely restricted to a limited amount of shares that I can purchase. The SEC monitors substantial purchases and sales of securities as the CFTC could just as easily monitor futures transactions. The SEC and the stock exchanges have been able to closely monitor and investigate, to their satisfaction, price fluctuations and transactions which appear suspicious in nature. I think the equity markets can provide a good example to follow in establishing a rational framework for the futures markets.

Further, speculative limits alone will not prevent squeezes and manipulations, since the unscrupulous mind undoubtedly will find a way to make or innovate a scheme to circumvent speculative limit requirements.

In 1975, the CFTC established an advisory committee on the economic role of contract markets. In July 1976 the committee issued a report of their findings, concluding that the then existing limits were unable to adequately address price manipulation and congestion in the delivery months. The committee further concluded that limits do not "effectively limit the abusive market power of the large commercial firms" that enjoy bona fide hedge exemptions from limits; and that the limits are not effectively tailored to delivery month conditions when the potential for manipulation is the greatest. The advisory committee further noted that limits are "not a very powerful tool nor can they be made to be so." Accordingly, the committee recommended that position limits "be supplanted by an improved monitoring and a surveillance program designed to achieve orderly liquidation of expiring contract months". The same advisory committee also recommended that the CFTC's existing limits not be imposed on new contracts, or on contracts without a limit.

From an economic perspective, the price discovery function in the futures markets largely depends on the existence of the speculator. It is highly unlikely that even the unscrupulous speculator would be able to put a squeeze on a contract in the nondelivery months, due to the enormous amount of money and financing entailed in creating a squeeze months before the delivery month. Thus, I believe, a funnel approach could be a useful way of addressing the issue. That is, the limits starting out on a particular contract would be economically flexible, and as the contract nears the delivery period, the limits would narrow.

I believe, the CFTC's previously noted study clearly shows that the silver situation is being exploited in the abstract. Different commodities have different underlying characteristics and deliverable supply. Assuming that someone, or some entity, was intending to squeeze a particular contract, and assuming that the individual or the entity had the financial resources to do so, certain contracts would be more susceptible to a squeeze than others. For example, to squeeze the cotton market would be much easier than the Swiss franc. There is a lesser supply of deliverable grade cotton than the Swiss franc. Thus, it may make sense that a rational funnel approach be taken in the cotton contract, with high or no limits imposed on the Swiss franc. Each contract should be examined independent of any predetermined irrational bias.

Industry proposals make clear that the CFTC may impose speculative limits, but that those limits must not be an end in themselves; they must have as their purpose the prevention of manipulation, corners and squeezes. In this connection, the industry proposal would require the CFTC to take certain factors, including volume, open interest, and arbitrage opportunities into account in determining the size of any speculative limits imposed on the market.

While as a compromise, I support the industry proposal, I recommend, as my earlier comments suggest, that we go further. While we recognize that speculative limits may be a helpful regulatory tool in some markets, I do not believe they are necessary in any market and can, in fact, be harmful.

I recommend that Congress direct the CFTC, either by legislation or, in the alternative, by language in committee reports, to reassess its rule requiring exchanges to adopt limits in all commodities, and to take steps to encourage the increasing of open interest in distant delivery months in those commodities where limits are imposed. It is the more distant months which are important to the hedgers—the primary beneficiaries of these markets—and it is the more distant delivery months that are most immune to manipulation, cornering and squeezing.

The funnel approach suggested earlier in my testimony would provide encouragement for speculators to take positions in the more distant months, thereby providing liquidity in those months which are most beneficial to hedging activities. This approach would allow for increased usage of the markets, while not increasing any susceptibility of a market to manipulation, cornering or squeezing.

Now to address the user fee point. Although the amount of the CFTC's proposed user fee appears to be insignificant, it is substantially higher than the fees being levied in the equity markets. Let us not forget that the CFTC user fee, if adopted, would be levied in addition to fees that will be paid to the NFA, the exchanges, floor brokers, and executing agents—it is significantly more expensive to execute a futures contract than it is to purchase or sell a security.

If we, as users, are to be taxed to support the CFTC's regulatory program, what are we receiving in return? The answer appears to be: More costly regulations and inflexibility. Why, I ask, should the ethical user of the marketplace pay for the regulations created by misdeeds of the criminal mind? Does it not make more sense for the CFTC to impose substantial penalties on a criminal and violator of the Commodities Act?

The industry, I believe, is very concerned about crime, violators, bucket shops, and schemes which infiltrate their business and create an appearance of an unruly, uneducated and unprotected marketplace. This appearance and image problem is of great concern to all ethical participants of the futures industry. Its reputation is at stake, at a time when the industry is steadily growing, and at a time when more sophisticated institutions plan to enter its active arena. Business for the industry can only grow if it can show to the potential user an economic benefit with reasonable safety. We all recognize this, and will attempt to rationally achieve this goal. To regulate is to rectify and improve, not restrain and constrict. Self-regulation, with CFTC and congressional oversight is, I believe, the rational approach to take.

Now permit me to focus in on the subject of the CFTC/SEC jurisdictional accord and legislative proposals. As a manager of significantly large publicly pooled funds, we are in basic agreement with the CFTC/SEC compromise, and strongly support the proposed legislative changes by the two agencies. The CFTC, SEC, and their respective chairmen must be commended for resolving this important and confusing issue, which in the past plagued the formation and marketing of publicly offered participations in pooled commodity funds.

In addition to the CFTC/SEC proposal, I would recommend that any rules and regulations to be promulgated under the adopted proposal be uniform and concurrent, so as not to create a potential for conflict in the manner and substance in which one is to comply with said rules.

The proposed CFTC/SEC legislation must also be absolutely clear, that in the area of commodity pools, only the CFTC and SEC will have clearly defined jurisdiction, and that the States' security "Blue Sky" regulations will be specifically preempted in all respects. Presently, I believe the States have neither the qualified personnel, nor the manpower to equitably deal with the commodity pool product. There is a considerable lack of understanding on the part of the States, of the futures markets and related investment products. Should the States be permitted to exercise any jurisdiction over commodity pools, I am afraid that the reaction may well be one of foreclosing the pool product in a particular State.

We believe that the CFTC, the SEC and the NFA will be well-equipped to protect the public interest in this area. Uniform regulations by the two agencies will also be cost effective, in that the pool will be subject to a well-defined national regulatory structure, instead of the potential of complying with 50 different guidelines, rules and regulations, which in the long run, may prove to be an expense not only to the promoter of the pool, but also to the prospective investor.

In conclusion, I wish to state for the record that the CFTC and its staff are being unjustly persecuted by the media and certain interest groups. In the past few years, and in particularly recently, under the leadership of its Chairman, Philip Johnson, the Commission has taken great strides in educating the public and making the futures markets safer than they were ever before. I have no doubt that the quality and understanding of this industry will continue to improve.

Thomas Jefferson in a letter to John Adams once wrote, and I quote, "I like the dreams of the future better than the history of the past." This should be the motto under which the industry and its regulators should work together and, ultimately, be judged, and if we all do a good job, then at the next reauthorization hearings, I will be able to comfortably state that I like the dreams of the future because we had a proud past.

Thank you, Mr. Chairman.

Senator LUGAR. Thank you very much.

Let me ask a question quickly. You have come down hard, I would say, in your testimony, with regard to the pools against State regulation at any point. One of the general areas of discussion during these hearings has been what role the States ought to play in enforcement of a number of areas.

Now, is there a peculiar aspect with regard to the pool resources that should lead to almost Federal preemption—I think that is essentially what you are suggesting—in that area, and not necessarily so in others? Could you make some comment as to how you draw your distinctions there of State and Federal regulations?

Mr. **Barbanel**. Certainly. I think the key there is uniformity of regulations. I think the States have reacted in a very negative way toward the pool product.

Senator **Lugar**. Why is this so?

Mr. **Barbanel**. I think, lack of understanding of the product. I think the publicity that the futures industry, and in particular, certain products, have received in the past few years have not been positive, and the reaction, I feel, from the States is that they do not wish to be criticized for permitting a bucket shop or some product that may injure the residents of that particular State. The reaction tends to be either over-regulating or restricting that product, than taking a chance and permitting a reputably offered product to take its valid business course.

Senator **Lugar**. In the case of a commodity pool, what is the public purpose to be served by such a thing? It is not price discovery, presumably, but what is the economic value?

Mr. **Barbanel**. There could be a number of economic values. I think a pool product can permit an individual, who has not had the experience in dealing with commodities directly and does not wish to take the risk of sizable margin calls and volatile movements in price, to invest in a commodity product where his risk is limited to the amount of money that he has invested, plus any profits that he has made. Also, a number of, for example, IRA accounts or pension funds may be interested in utilizing the pool area as a hedge against their portfolio without exposing themselves to margin calls and excessive, volatile price movements.

And the third point that I can make is; it would serve a function, just like any investment vehicle does, such as in the securities industry, where mutual funds, for example, have been a valuable resource of bringing more investors into the securities and equities business without creating the risk, or to spend 24 hours a day monitoring their investment.

Senator **Lugar**. Simply for the record, is an investor in a commodity pool estimating that commodities as a total group will go up or down? Isn't the nature of the pooled effect to knock out all the different trends in individual commodities and to make a judgment as to whether the total group of commodities will go up or down, and is such an estimate rational?

Mr. **Barbanel**. Well, it is a little bit more depending on who manages the pool and how scientific you are about structuring the pool. Generally, my feeling has been that a pool is basically diversity, and that is that you do not place a large sum of money and risk it on any particular contract to go up or down, but what you do is, by investing in a group of commodities at a much lower price than you would be able to directly in the futures industry, have the diversification, and minimizing the risk of any particular contract to go up or down.

Senator **Lugar**. We appreciate your testimony very much. It is very interesting and an important concept, as well as your comments on the jurisdictional accord.

Thank you.

Mr. **Barbanel**. Thank you, Mr. Chairman.

Senator **Lugar**. The Chair would note that we have been joined by the chairman of our committee, Senator Helms of North Carolina.

I would like to call now on Don Eret of the American Agriculture Movement.

Welcome, Mr. Eret. It is good to have you with us this morning. If you would, please proceed.

STATEMENT OF DON ERET, ON BEHALF OF THE AMERICAN AGRICULTURE MOVEMENT, INC.

Mr. **Eret**. Good morning, Mr. Chairman.

I am Don Eret, a farmer from Dorchester, Nebr. My statement is on behalf of the American Agriculture Movement, to call attention to the fact that the Commodity Futures Trading Commission is not conforming to regulatory requirements set out in the Commodity Exchange Act. Attached to my written testimony is a copy of my statement on this same subject presented to the House Agriculture Subcommittee on Conservation, Credit and Rural Development last Wednesday, February 24, and I request that this be put in the record for further reference.

Senator **Lugar**. Without objection, it will be made a part of our record.[1]

Mr. **Eret**. Today, I will go into additional detail.

Provisions were enacted in the Commodity Exchange Act to limit or abolish speculative short-selling of commodity futures contracts when such selling creates an economic burden on the interstate commerce of the subject commodities. It is a fact that prices of grain have fallen well below the costs of production. Producers are not currently selling grain in quantity in order to delay realized losses and to await improved prices. In the meantime, thousands of grain-hopper cars are idled, and many thousand railroad employees are laid off of their jobs. This, then, is actual proof that a burden exists on the interstate commerce. Yet, the CFTC has not taken any action to further limit or abolish the inherently price depressing speculative short-selling in grain commodities.

The American Agriculture Movement has twice filed a petition with the CFTC in accordance with provision of CFTC regulation, paragraph 13.2, under public rulemaking procedures. The first was on April 25, 1980, and again, with additional justification, on March 6, 1981, to appeal for relief against the price-depressing effect of speculative short-selling and to offer a beneficial speculation rule. A reply was received from the CFTC only to the first petition and was dated September 26, 1980. The response was not acceptable in its logic. It tried to make a case for the position that if speculative short-selling was limited that the liquidity of trading would not be insured.

We do not find anywhere in the act that the Commission is charged with the responsibility of maintaining liquidity. We do, however, find and also agree with the statement of Mr. Culver in his letter acknowledging receipt of our first petition that the Commission is responsible that the markets must accurately reflect the forces of supply and demand. We expect this rationale to be accomplished in accordance with the stated provisions and legislative history of the Commodity Exchange Act to prevent. One, unreasonable fluctuations or unwarranted change in price of commodities, and two, undue and unnecessary burden on interstate commerce of commodities.

---

[1] See p. 506 for the statement of Mr. Eret before the House Agriculture Subcommittee on Conservation, Credit and Rural Development.

Speculation in commodity futures is allowed as a legal practice under Federal law for the express purpose of shifting or assuming commodity ownership risk. Federal regulation of commodity futures speculation should then restrict speculation to this intended beneficial purpose of transferring ownership risk without at the same time destroying property value of the commodity to the extent that a burden develops on the interstate commerce of the commodity.

It is for the purpose of maintaining this objective that the American Agriculture Movement has adopted and offers to the Congress the beneficial speculation rule for enactment into the Commodity Exchange Act by the Futures Trading Act of 1982 to read as follows:

> It shall be unlawful for any person directly or indirectly to acquire a speculative net short position with contracts sold at a price below 90 percent of the USDA parity price or to acquire a speculative net-long position with contracts purchased at a price exceeding 110 percent of the USDA parity price for any U.S. producer marketed agricultural commodity traded in futures on any contract market.

This rule is considered as falling well within the definition of the authority of the CFTC to limit or abolish speculative short-selling and yet not duly restrict trading except in those price ranges most detrimental to both producers and consumers.

Furthermore, no budgetary consideration is necessary in enacting this safeguard.

We feel that the Agriculture Committees of Congress must speak in terms of statute rather than discretionary authority in this important matter.

I will attempt to answer any questions, Mr. Chairman.

Senator LUGAR. Thank you very much, Mr. Eret.

Mr. Eret, in attempting to establish a market, what would happen in the event that supply and demand for a commodity have almost no relationship with the parity price? That often is the case, as I think you have noted, or your organization has in previous testimony, and you have asked us to bring our prices of commodities up to something close to parity, and you have noted that, as a matter of fact, in terms of the index that we have looked at, maybe 50 or 60 percent of parity.

Mr. ERET. Yes.

Senator LUGAR. In that case, we might have no market at all. What sort of suggestions do you offer to us as to how market would be produced?

Mr. ERET. Well, parity is always the thing that we speak of in terms of balanced national economics—in other words, to avoid possibly problems like we are having in current times. But I think our proposal there is trying to identify some sort of an approach to zeroing in on the beneficial area of the use of speculation in a range—and it would not be specifically what we stated—but in some range that would be acceptable to everybody where it would target the beneficial area and not allow the speculation to go off into the areas that become a burden.

Senator **Lugar**. I see. In other words, if some sort of price discovery could occur in the market, your hope would be that the oscillations up and down from that area would be limited, wherever that supply and demand might take it?

Mr. **Eret**. Well, to try to get into an area where we do not get into a stalled and sale market like we have now.

Senator **Lugar**. Well, of course, all of us hope for—and I am included among those—I would like to see the price go up. The problem that I see is that the commodity markets hopefully discover the price that corn is worth to somebody right now, in terms of the supply and demand, and I wish that the signals were higher. And yet, I am not sure how by law, and particularly, in our oversight function at CFTC, we can peg things, really, in that comfortable an area.

Mr. **Eret**. Well, it seems like in reading the Commodity Exchange Act and its initial legislation back in the previous economic hardship back in the thirties, that Congress at that time had an outlook to try to maintain the economy, and so in doing that, they used the rules they did to try to—in other words, now, with the market down, before it can come back up, we feel that we need to have the depressive effects somehow relieved so the market can regain its position pricewise. And the only alternate solution we have heard from the CFTC is, if speculation is a problem, let us increase the margins for the speculators. Well, we do not really see that as a problem. That does not direct it back to the center ground. That would, in fact, put the burden on the speculators, the ones who are doing the best trading, to take opposite sides of our position. So we cannot exactly buy that solution either, and that is why we are trying to suggest something that would be a valley-shaped or a funnel-shaped system that would always direct the market to a center ground that is beneficial to all.

Senator **Lugar**. Senator Helms, do you have questions of the witness?

The **Chairman**. One or two.

Mr. Eret, we welcome you to the committee. I have a question that Senator Lugar raised about the effect of implementing your suggestions. What would 90 percent of parity be equivalent to in dollars and cents?

Mr. **Eret**. Well, with corn, it would be about $3.60, I believe.

The **Chairman**. What would 110 percent be?

Mr. **Eret**. It would be something over the $4 mark.

The **Chairman**. The problem is that no corn is moving at those prices; is that right?

Mr. **Eret**. Well, not right now, no.

The **Chairman**. Well, as a matter of fact, there just would not be any futures trading under——

Mr. **Eret**. No. The long speculators would not be prevented from taking long positions, and in fact, it would take the position to limit the speculative short, to protect the beneficial speculators, the ones that would be taking the long positions opposite the production short side positions. There would be nothing to keep them from trading.

The CHAIRMAN. So you are not saying outlaw futures trading?

Mr. ERET. No, definitely not. This is not the intent of our testimony. It is just to implement the way we understand that the Commodity Exchange Act was implemented in 1936, with the introductory paragraph. And I think the word, "abolish"—they say to limit or abolish—more specifically, they say speculative short selling, and if you read the congressional history of that act, I think possibly, the word, "suspend" would be an acceptable substitute word. In other words, when the problem clears, they could go back into trading in that area.

The CHAIRMAN. This is a complicated area, and I have to confess, Mr. Chairman, of all the issues that have come before this committee in the 9 years that I have been on the committee, this is one I have had to do more homework on, and I am not sure I understand it yet.

Mr. ERET. It is a very complex thing to analyze.

The CHAIRMAN. Well, I certainly appreciate your coming. Thank you very much.

Senator LUGAR. I do, too, Mr. Eret. Thank you for helping us.

Mr. ERET. Thank you.

Senator LUGAR. I would like to call now William Brooks, president of the National Grain Trade Council.

Good morning.

STATEMENT OF WILLIAM F. BROOKS, PRESIDENT AND GENERAL COUNSEL, NATIONAL GRAIN TRADE COUNCIL

Mr. BROOKS. Thank you, Mr. Chairman.

I have got permission, and I have been requested to file with you a statement for the Minneapolis Grain Exchange. Their witnesses were unable to get here, and there it is for the record, please.

Senator LUGAR. We would be happy to have that. Thank you very much.

Mr. BROOKS. Then I have a statement here that we submitted to the House Banking and Currency Committee back in 1973 on margins, which may help you if any discussion comes up in that particular area.

Senator LUGAR. We will include it.[1]

Mr. BROOKS. Thank you very much.

The National Grain Trade Council, an organization whose policymaking members include grain exchanges and boards of trade, both cash and futures, and certain national grain marketing associations, appreciates this opportunity to present again our views on proposals to extend the Commodity Exchange Act.

We generally support the reauthorization of the Commodity Futures Trading Commission and an extension of the Commodity Exchange Act. Our comments will be directed to 26(b) of S. 2109. This section, if enacted, would in effect make designated contract markets Government agents to assess, collect, and pay over to the Treasury what are euphemistically called fees to recover appropriated funds covering the Commission's activities.

The council recommends that section 26(b) be not enacted.

---

[1] See p. 508 for the 1973 statement of the National Grain Trade Council before the House Banking and Currency Committee.

The CFTC is, like other independent regulatory agencies, an arm of the Congress. Its report for the year ending September 30, 1981, should therefore be of interest to this subcommittee and the Congress. The opening paragraphs of that report state:

> The ability of the Nation's futures market to transfer commercial risk and to serve as an informed and widely quoted guide to prices has provided economic benefits. Futures markets have become a valued resource in a world long on uncertainty and short on stability. Because futures markets are well-organized, production costs have been gaged more accurately, prices that allow for a reasonable profit have been set more surely. Borrowing and lending to fuel our economy has been accomplished with more certainty.
>
> The Commodity Futures Trading Commission is the 7-year-old Federal regulator of the Nation's futures markets. It is the Commission's responsibility to regulate the exchanges, brokerage firms, salesmen, pools, advisors, floor brokers, and clearinghouses. And if customers reach a size where they can influence market prices, the Commission regulates them as well.
>
> Commission regulation consists primarily of licensing, market surveillance, and rules against manipulation, fraud, and noncompetitive trading. Licensing is a screening device in the first instance, and acts as a continuing check against unfitness. Market surveillance is ongoing policing against people-inspired market disruption. Rules regarding business ethics define the permissible boundaries of behavior in dealing with the investing public. These are the Commission's core functions.
>
> The Commission is also responsible for studies of the markets for education and for operating a unique "reparations" program in which it can award damages to injured market participants under certain circumstances.

In furtherance of the CFTC's mission to protect the public, the report at page 15 notes:

> During fiscal 1981, the agency's enforcement efforts achieved monetary relief—through the appointment of receivers to protect customer funds, the return of funds to customers and civil penalties to the U.S. Treasury—that nearly equalled the Commission's entire budget.

All these services to the public come through divisions, sections, and offices of the Commission. Their titles confirm the nature of the public service they perform.

The Commission has (1) divisions of enforcement, of economics and education, and of trading and markets; (2) sections devoted to audit and evaluation, to complaints, and to hearings; as well as (3) Offices of Governmental Affairs, of Public Information, and of Congressional Affairs.

Many persons and business entities in agriculture use futures markets and the future market price discovery processes as a basis for business decisions without ever entering into a future contract to buy or to sell. These include producers of wheat, corn, oats, soybeans, sunflower seeds, and commodities manufactured from them. The Department of Agriculture uses these quotations in the operation of its commodity programs.

The section 26(b) levy would directly fall on the active participants in futures trades. The levy, determined without any cost-benefit analysis or analyses to indicate what market participants benefit from some or any of the Commission's activities or to indicate what the cost of those unidentified benefits might be, will lessen the effectiveness of the price discovery process of contract markets and will have adverse effects on direct participants in the market.

The section would impose unwarranted and large costs on scalpers and commercial hedgers—country elevators, terminal elevator grain merchants, exporters of grain and oilseeds, flour millers, feed manufacturers, corn processors, soybean processors, and others.

Floor traders or scalpers, who are in the markets on a daily basis, trading hundreds of contracts in hopes of making a profit on small changes in prices, would bear a disproportionate burden of any transaction tax. These traders are of critical importance to the markets as they provide needed liquidity to permit a large hedger, such as a grain firm, to hedge their purchase or sales of cash commodities with minimal market effect.

A user tax would adversely affect hedgers because their marketing costs would increase as market liquidity decreased due to the number of floor traders who would cease doing business because of the tax. Floor traders who stay in the market will attempt to increase their margins to cover the cost of the tax. This increase will be passed on to the commercial users, the hedgers.

The increased cost to the hedger, be it grain firm or processor, will in turn be reflected in a lower price to the producers of wheat, corn, oats, soybeans, and sunflower seeds.

For agricultural commodities, Mr. Chairman, the farmer will ultimately bear the burden of the section 26(b) levy.

The council, on June 2 of last year, recommended to the CFTC that the application of the National Futures Association for approval be approved. It was approved. And now comes this section 26(b) levy that threatens the possible demise of this particular industry-funded body.

If Congress approves the section 26(b) levy, the self-financed, self-regulatory proposals and structures of the National Futures Association will not function efficiently or effectively, all to the detriment of the public.

We believe that the association deserves a clear track to prove its capabilities, unencumbered by unorthodox, non-Federal financing.

We believe that if section 26(b) is enacted, the ability of the Nation's futures market to transfer commercial risk and to serve as an informed and widely quoted guide to prices will be impaired and that those markets may no longer be regarded as a valued resource in a world long on uncertainty and short on stability.

In view of the foregoing, the National Grain Trade Council recommends that section 26(b) of S. 2109 be not enacted.

If you have any questions, I will be glad to try and answer them.

Senator LUGAR. Thank you very much, Mr. Brooks. Certainly, your testimony is straightforward and unambiguous in regard to section 26(b).

Mr. BROOKS. Thank you.

Senator LUGAR. I suppose the problem the committee faces, and you have heard this discussed now with a number of witnesses, is to try to determine what portion of the general cost of regulation should be borne by the taxpayers in general, the general public, and what portion should be borne by those who are most active. And clearly, as you pointed out, it may be that a user fee hobbles the speculative function, the price-finding function, of those who provide liquidity in the market. Many have made that point, and you have done so eloquently.

At the same time, the general budgetary problem of the Federal Government dictates that each one of us attempt to find how to cut the costs of some of these regulatory mechanisms, and that has been a part of our attempt to discover some things during these hearings.

In your judgment, what portion of all of this is public as opposed to private benefit, and how should we try to allocate the expenses, if we can possibly do so?

Mr. BROOKS. Well, I would first answer that by saying that you can act in haste and repent at leisure. We have had some experience in this industry with user fees. This has to do with the user fee in warehouses and the user fees under the Federal Grain Inspection Service, and those questions have not yet been resolved, although the outlook, when they were put in, and the OMB thought, "This is a great thing, and we are going to eliminate some costs." It turns out it does not work out that way because of the interest of the users of these facilities, the farmers and the other people who would have to change their programs.

Now, to be more specific or attempt to be, I was interested to hear this morning, of course, the General Accounting Office talking about appropriate user fees and the need to distinguish between those areas where there is a public interest and those where some person has especially benefited. The SEC has some fees—and I cannot enumerate them all—but they come from registration of securities issued, and this is regarded as a benefit to the particular of the SEC. Qualification of trust indentures; registration of exchanges; registration of brokers and dealers who are registered with the SEC but not members of the National Association of Security Dealers; certification of documents filed by the Commission—they do not use a transfer fee. Now, I am suggesting that this particular transfer tax, as I refer to it, my information is that the CFTC attempted, in the brief time that they had to look into it, to have the staff develop some information about it, and the staff, either because they did not have time, or obviously because they did not have time, the problem seemed to be one that required a devil of a lot of study. And it seems to me that this subcommittee could, with some substantial benefit, go to the sponsors of this proposal and say:

> Are there not some fees, not unlike those charged by the SEC, that do have special benefit to people who are coming in here, making requests for documents, making requests for licenses and permits?

Senator LUGAR. Mr. Chairman, do you have questions?

The CHAIRMAN. I just want a little enlightenment. As I said earlier, this is probably the most complex matter to come before this committee in terms of fully understanding it.

Tell me how a commodity option could be used by a farmer.

Mr. BROOKS. I guess the best way to answer your question—I noticed you had an insertion in the Congressional Record; there was an article in there by a gentleman from the University of Maryland and also an article by Mr. James Culver, of the CFTC—I think the answer is in those articles that you inserted in the record.

The CHAIRMAN. Well, I profess it was a leading question, Mr. Chairman. I just wonder if you agree.

Mr. **Brooks**. Well, it seems to me that, with the Farm Bureau talking the way they do, that the possibility of farmers being able to use the options as hedges for agricultural commodities, I would agree that this deserves a lot of consideration. But I want to be sure that the producing communities endorse this thing as does the Farm Bureau before you get into it.

Senator **Lugar**. Mr. Brooks, one last question. Staff has reminded me that the SEC has a transfer tax on stock transactions. Is there some analogy between what the SEC is doing and what the CFTC ought to do?

Mr. **Brooks**. No. This is the point and the burden of this talk on margins. The margins on commodities are one thing, and they are something else—completely something else on securities. Now, a transfer tax in securities is a fee. Somebody is building up an equity. It is an investment. People are in and out of futures market, and this is a transfer of risk, it is a price-determining mechanism, and you just cannot equate them.

I mentioned the SEC fees only in connection with possible areas where you could go to the CFTC and say, "Charge for this and charge for that."

Senator **Lugar**. Thank you very much for coming.

We have concluded the hearing at about 11:30, as we had aimed to, given the votes on the floor, and I appreciate the concise testimony of the witnesses and your indulgence of the schedule of the Senate.

This concludes our third hearing. We will have a fourth and a fifth round next week, and those who are interested in this subject are invited back for those occasions.

Thank you very much.

[Whereupon, at 11:33 a.m., the subcommittee recesssed, to reconvene, Wednesday, March 10, 1981, at 9:30 a.m., in room 324, Russell Senate Office Building.]

COMMODITY FUTURES TRADING COMMISSION REAUTHORIZATION

WEDNESDAY, MARCH 10, 1982

U.S. SENATE,
SUBCOMMITTEE ON AGRICULTURAL RESEARCH
AND GENERAL LEGISLATION OF THE
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:30 a.m., in room 324, Russell Senate Office Building, Hon. Richard Lugar (chairman of the subcommittee) presiding.

Present: Senators Lugar, Hayakawa, and Huddleston.

STATEMENT OF HON. RICHARD G. LUGAR, A U.S. SENATOR FROM INDIANA

Senator LUGAR. This hearing is called to order.

This will be the fourth day of hearings on the CFTC reauthorization, and it is a pleasure to welcome as our leadoff witness this morning, a former associate of mine, now a distinguished Assistant Secretary for Economics, Department of Agriculture, Bill Lesher.

Bill, would you come forward? And why don't you sit over here with your colleagues and present your testimony.

STATEMENT OF HON. WILLIAM G. LESHER, ASSISTANT SECRETARY FOR ECONOMICS, U.S. DEPARTMENT OF AGRICULTURE

Mr. LESHER. Good morning, Mr. Chairman. It is a pleasure being here today.

Before I begin I would like to introduce my deputy, Dawson Ahalt, to my immediate right. Beside being my deputy, he's the official liaison person within the Department of Agriculture for the CFTC. We have two senior economists in the Economic Research Service, who helped in preparation of the testimony, Allen Paul and Richard Heifner. After I finish, hopefully, between the four of us, we will be able to answer most of your questions.

This is a fairly complex issue concerning trading of agricultural options.

We have taken the liberty, Mr. Chairman, of preparing a rather lengthy testimony. Trading of agricultural options has been banned since 1936 and for this reason I think it is important to understand the conditions which existed in the mid-1930's which brought about the prohibition on agricultural options trading. So whenever you entertain lifting that ban, I think it's important to get a historical perspective and the most detailed documentation we can for the record. If it would be OK, I would like to submit that for your hearing record, and then I would like to, if I may, Mr. Chairman, read the first two pages of the statement, which really give an overview, and then make a few additional comments and then go to questions.

Senator LUGAR. All right. Without objection, your whole statement will be made a part of the record, and we would be pleased for you to summarize it, as you have suggested.[1]

Mr. LESHER. All right. I will read the first two pages which give an overview of the position of the Department of Agriculture and the administration, and then I will make some brief remarks after that.

It is a pleasure being here today before you and Senator Huddleston, to discuss the importance of futures trading to agriculture, to support generally the reauthorization of the Commodity Futures Trading Commission and specifically to support lifting the ban on trading in options on farm commodities.

Futures markets provide forward pricing and hedging mechanisms that greatly facilitate the efficient marketing of farm products. The prices generated on futures markets are widely used as indicators of value and as guides for production and storage decisions by farmers and other businessmen. And the shifting of risk provided by active forward markets greatly aids the mobilization of capital in production and marketing.

But futures trading is subject to various abuses. Experience has shown that effective regulation at the Federal level is needed to protect producers and other traders. The Department of Agriculture strongly supports the reauthorization of the CFTC to provide this protection.

I would like to go on and explain why we feel the prudent introduction of options trading for farm commodities could benefit farmers, others in agriculture and the general public. I will talk a little bit about an overview of options trading, popularly known as puts and calls trading, and identify some of the issues involved. The reasons options trading was banned in 1936 will be reviewed, and the differences between the past options trading and what is envisioned will be described. The relation between options trading and price supports, the possible benefits to farmers from options trading by marketing firms, and the potential problems with options trading will also be discussed.

As an overview, Mr. Chairman, farmers, especially small- and medium-size operators, might benefit substantially from well-functioning commodity options markets for crops and livestock. Options trading could increase efficiency in agriculture by facilitating more effective risk transfer. While it may take some time before viable agricultural options markets develop because certain issues will have to be addressed and resolved, no progress can take place until the ban actually is lifted.

The main reason for banning options trading in 1936 was to stop abusive practices. While abuses did occur in the past, it seems that the ability of both the commodity exchanges and the CFTC are adequate to insure that similar abuses would not occur today. The potential problems of options trading do not appear to be insurmountable and only could be solved after the ban is lifted—but before trading is allowed. In view of the potential usefulness of options trading to agriculture, yet great uncertainty over how far this potential could be realized, the Department of Agriculture recommends the removal of the 1936 ban on agricultural options trading, subject to the understanding that such trading would not start until after the CFTC and the commodity exchanges have completed their pilot program with options trading of other commodities, evaluated its feasibility, and developed procedures that are essential for effective control of trading abuses.

---

[1] See p. 513 for the prepared statement of Mr. Lesher.

Now, with that sort of overview, Mr. Chairman, I would like to make a few other comments.

Our testimony, Mr. Chairman, stems from a belief in the Department of Agriculture that marketing is a problem for agriculture and we think especially for the small- and medium-sized operators. While large operators are more sophisticated in their knowledge of futures trading and are use to the marketing calls and all the other complications that go along with futures trading, we don't think that the small- and medium-sized operators utilize that market fully.

We think that agriculture options may be one tool that they would use. We're not talking about tomorrow, we're not talking about next year. We're really talking about 3 or 4 years from now, perhaps even longer. But I do think it would provide the small- and medium-sized operators with another marketing mechanism, one of reducing risks.

And, Mr. Chairman, you're from Indiana, let me give you an example. Corn prices about a year ago in north central Indiana were over $3 a bushel—roughly $3.39—and right now it's probably about a dollar less. This is an example of how an Indiana farmer could use agricultural options in trying to reduce some of that risk that ultimately occurred. A farmer could look at that situation and decide he wants some protection on the downside. He knows he has a price support of $2.40 per bushel, but that's not high enough for him to make a profit and he would like some downside price risk protection. He could buy a put, meaning buying the right to sell corn at a later date, in a specific quantity, at a specific price, for example $3.25 a bushel. He would then not have to exercise that right unless the market price went down. For that right to sell that crop at that $3.25 a bushel, he would have to pay a premium to someone. There has to be someone on the other side buying the call.

And that is in simple terms, Mr. Chairman, how a farmer could utilize agricultural options trading. We're not saying that there would be no problems. There are many problems that must be resolved before you could have a viable agricultural options market. I think one of them is that the ability to put a squeeze on the market occurs with options just as it does with futures trading. I think there is some question as to the cost. The cost may be too high for the farmers. In other words, to buy that right to sell corn at $3.25 per bushel may be too much for him to bear. We just don't know. But that's another problem—whether you're going to have a viable market in the end.

For an individual farmer, the purchase of a put option has some similarities to entering into a price-support agreement with the CCC, except that the farmer rather than the taxpayer would bear the cost of reducing the exposure to a significant price decline. Options trading would not be as attractive to most farmers as price supports, assuming other conditions were equal—the support price equals the striking price, no restrictions on plantings, or other factors.

Because price supports and commodity options generally serve the same purpose for an individual producer, the farmer's use of options would largely depend on how close support prices were relative to market prices. The same thing is true of the use of futures contracts, as the history of cotton and grain markets indicates. Thus, the rise of options trading depends on Government policies. Since price supports are normally below market-clearing levels to avoid interfering with our share of international trade, many farmers—especially those who are young or highly leveraged or both—may desire to reduce their risk at a price much higher than the price-support level. This is especially true since agricultural markets have become much more variable in recent years.

Unlike agricultural options, however, the price-support program provides a floor, nationally, for certain farm commodities. In addition, an options market could function efficiently for farm products other than storables, such as livestock. The main requirement is fungibility and unmonopolized supplies—the same conditions required for successful futures trading.

Well, I should add, there is no free lunch in this, Mr. Chairman. I don't want to give the impression that allowing agricultural options trading is going to benefit all farmers. In the long run, the economics of it would be that losses 1 year will be offset by gain in the next year. In the long run it will equal out in a competitive bidding process on the exchange. But still it would give farmers, and especially those who produce or raise commodities that do not have a price support, such as livestock, a price floor.

In sum, Mr. Chairman, you could state our position as simply saying we think the ban should be lifted. We think that it should be a go-slow approach. We think that the results of the pilot projects now going on should be evaluated before you move into the full blown trading of agricultural options on the exchange. There may be some problems, as my testimony indicates, but I think that prudently and cautiously, over time, we could develop another avenue for farmers to reduce their risks and it would be another marketing tool.

And with that, Mr. Chairman, I will stop and be glad to entertain any questions which you or Senator Huddleston may wish to ask.

Senator LUGAR. Thank you very much, Dr. Lesher.

To complete our record, I have three questions. First of all, Chairman Johnson of the CFTC has testified that he would not support the lifting of the ban on agricultural options unless there seems to be a general consensus among the agricultural community in support of options on agricultural products.

Has the USDA conducted any surveys of the various agricultural groups to determine their interests and views on this issue or do you have any informal indications of how agricultural groups might feel?

Mr. **Lesher**. Well, that is a difficult question, because I don't want to be a major spokesman for each of the farm groups and misstate their position. It seems that some of the major farm organizations may be supporting it. Decisions on that may come shortly, perhaps today. Others seem to indicate that they are not opposed, but yet are not going to be actively seeking trading in agricultural options, at least right now, because of some of the negative tones. Whenever you mention "options," the image is not that good. And so I think there are some that may think it's a good idea, implicitly, but they are not anxious to state that publicly at this time. And there may be one or two organizations that would not support it. I think it's hard to say if you asked Indiana farmers whether they would support it or not. There would be an educational problem involved.

I think, though, that with an educational process it would be favorable for agricultural producers. Because the one main advantage is that you provide protection on the downside by paying a premium. You know what your total costs are ahead of time, but you still don't have to exercise that right in case the price goes up. My dad is a farmer, your dad is a farmer and many others in this room have come from agricultural backgrounds and farmers dearly love to wait for higher prices and I don't blame them. That's one of the advantages of trading in agricultural options.

Senator **Lugar**. Dr. Lesher, what factors would affect the price of the premium charged agricultural options? Do you believe that there should be evidence of competitive pricing of nonagricultural options during the CFTC's pilot program process before the Commission should permit agricultural options?

Mr. **Lesher**. Yes. I think that you have to go through the pilot program before you ever proceed with agricultural options. I think it's essential to work out some of the bugs and get an evaluation from that.

The cost of the premium will depend on a number of things. First, if options are not competitively traded, you're not going to get the lowest transaction's cost. In addition, there are a number of other factors. You would have to have an extreme degree of standardization in the contracts and all of the other sort of criteria that you now have on futures contracts before you're ever going to have an effective trading of agricultural options at the lowest possible cost. You must get things standardized all the way down the line.

Even with all that, the price for the premium will depend on what kind of price protection you want, $3.25 a bushel versus $2.60 a bushel. Obviously, the premium is going to be different. Even with all the competitive trading in the world, it still may not be viable, at least at the higher so-called striking prices. But I think the market would sort that out.

Senator **Lugar**. Do you have any estimates of what percentage of farmers currently use the futures market as a risk management tool and do you anticipate similar participation in the trading of agricultural options if the 1936 ban was lifted?

Mr. **Lesher**. Allen, what do you think? Mr. Chairman, it's hard to say for sure how many farmers do use futures. You can use them in a very direct way, going through a broker and hedging; or you can go down to your local elevator and forward price and when you do that, then the elevator operator is using the futures.

Allen, do you have anything to add?

Mr. **Paul**. That's precisely right. The percentage of farmers that use it probably is on a low side, directly. The larger ones, the commercial ones will find ways of handling it directly. But the usual practice is to go to a local buyer who will stand to make in the commercial areas, make offers for delivery at firm prices and he is only able to do that because he, in turn, can lay it off on futures. If he could not lay it off on futures, the probabilities are that those contracts would not be offered.

So, one must think of this in terms of the system of sellers, buyers, and intermediaries. I would suppose that with options trading it would work pretty much the same way. While it is a simpler idea and probably more farmers could get to use it directly than futures, because it doesn't require margining of accounts and the complications that futures has. Still, many of them—the intermediaries probably would offer an option to the farmer, and he, in turn, would lay it off on someone else or in futures. Most likely it would be tied together and it would be interdependent.

Senator **Lugar**. Through direct or indirect methods, would you estimate that one in four farmers, for example, are now using the futures markets, or is it higher or lower? What do you think?

Mr. **Paul**. Well, I would have to go by commodity, I suspect. You know, grains have been around a long time. I would suppose it would be quite a bit higher for the grains than it would be some of the newer ones. And I am at a loss to say, I mean, if you would like an answer I would say for grains, a quarter sounds good to me. I deal in quarters.

Senator **Lugar**. All right.

Now, Senator Huddleston, do you have questions?

Senator **Huddleston**. Thank you, Mr. Chairman.

Mr. Lesher, I notice that you, speaking for the Department, unequivocally support the reauthorization.

Mr. **Lesher**. That's correct.

Senator **Huddleston**. From the CFTC, we still hear reports that investigations are going on and that fraud and swindles continue in futures and marketing trading. How would you compare the regulatory efficiency now, under the CFTC, as compared with the days when the Department was principally responsible?

Mr. **Lesher**. Back in the days when the Commodity Exchange Authority, the CEA, was in the Department of Agriculture, we did have an oversight in regulations in futures markets. Senator Huddleston, I can't say how well they are done now or how well they were done before. I think what you're really driving at is that we would not look forward to receiving that jurisdiction now. We think it makes a lot of sense to have the authority over all futures trading in one independent agency. I think it makes sense from not only efficiency of the industry, which benefits farmers and consumers, but also for the benefit of those trading. They have one place where they can go and have the same kind of regulations and not have to go to six different agencies.

Senator **HUDDLESTON**. Well, the growth of industry would have some bearing on that question, wouldn't it?

Mr. **LESHER**. Yes; and as you know, futures in the past, agriculture futures, predominated at least on most of the exchanges. But now financial futures are really growing by leaps and bounds and I really don't think that the Department of Agriculture would be the appropriate Department to regulate these futures. In addition we would not support spliting off part of it, say agriculture futures, and sending it back to the Department of Agriculture. I think that would be a move in the wrong direction.

Senator **HUDDLESTON**. Well, it seems unreasonable to expect that just because you pass laws or form a regulatory agency that all of the fraud and corruption is going to disappear.

Mr. **LESHER**. No.

Senator **HUDDLESTON**. We have a lot of other crime continuing in the country, but nobody suggests to abolish the FBI. And I guess the real question is how much more there would be if there were not CFTC and no regulatory efforts. How many people——

Mr. **LESHER**. How much more fraud there would be?

Senator **HUDDLESTON**. Right.

Mr. **LESHER**. Well, Senator, I can't answer that.

Senator **HUDDLESTON**. I'm sure you can't. I just posed that as a hypothetical thing.

Mr. **LESHER**. Well, I think——

Senator **HUDDLESTON**. And I think the people, really, that are being served by this activity are people that you never hear from, people who are saved from some kind of fraudulent activity or some kind of swindle just because the regulation was in place.

Mr. **LESHER**. Whenever something happens in the futures market it seems to make the papers rather quickly. I think one has to take a little bit broader and deeper view of things and I think that in general the CFTC is doing well. I think they are working hard. I'm sure they have room for improvement in certain areas and I'm sure they would come up and admit that to you. However, I think with some time that they will continue to improve and reduce the amount of fraudulent activities. And I think the industry is trying to increase its efforts also to self-regulate itself.

Senator **HUDDLESTON**. Now, the Department recommends lifting the ban on options trading in agricultural products. But you say not until the pilot projects have been completed, have been evaluated, feasibility determined, and procedures developed.

Now, who should make that final decision, in your judgment? Should that come back then to the agricultural committees or to the Congress as a whole.

Mr. **LESHER**. I'm not so sure it would have to come back to the Congress as a whole or the committees. I think that the ban could be lifted with a proviso stating that no active trading of agriculture options could take place, or some such language, until the pilot projects were tested and evaluated and the feasibility of moving into agricultural options could be assessed. Until you lift the ban, though, you will not get a dialog going on this issue, and you will not get people in the CFTC and the exchanges and the farm groups—the whole industry—to start thinking along this line. And I think that is the important step.

You could put in the caveats that need to be there. That is the only reason we say lift the ban now rather than later. It is important to get the dialog going and people thinking in this direction and it would be helpful in the long run.

Senator HUDDLESTON. Now, you indicate and I find as I travel around in the State, that more and more farmers are using the markets for their own purposes, and yet there is still a good deal of misunderstanding out there by some farmers who look on the futures markets as a problem for them. Saying that they set low prices rather than reflect the prices.

I have plugged for a long time the kind of educational program that you referred to. Who should conduct that, in your judgment? Whose responsibility is it? Should it be the CFTC or the Department, or both? Should farmer organizations play a role? It seems to me like there is a great potential out there.

Mr. LESHER. Oh, there is.

Senator HUDDLESTON. For not only a better understanding of what the markets are generally all about, but better ways to use the market.

Mr. LESHER. Senator Huddleston, I agree 100 percent. Perhaps the reason I have some interest in this issue and the marketing issues is that I come from a fairly small family farm by today's terms of size in Indiana, about 300 acres. I look back on things and we probably sold 75 percent of the time on a low market. My dad and I used to discuss this, and we would talk about using futures and other marketing tools. One thing a son learns very quickly is that father knows best and so you keep your mouth shut after a while.

But I think there is a great potential in education.

Senator HUDDLESTON. The question is how should we get it done?

Mr. LESHER. Well, that's a harder question. I'm trying to avoid answering that one. But I will take a stab. I think the CFTC should have a role, but I'm not so sure that they should have the responsibility for working directly with the farmers.

Senator HUDDLESTON. It seems like we put something in previous legislation defining CFTC's responsibility in this area. Did we, Bill, in the last bill, give CFTC the authority to conduct an educational program?

Mr. LESHER. I think what it would take would be for the Department of Agriculture, especially the marketing specialists and the CFTC, to get together to decide on some kind of program and then use the Cooperative Extension Service to develop the information. I think that's the only way that you're going to get a widespread educational effort going.

Senator HUDDLESTON. I think that makes sense. If you could teach all investors to accept the Will Rogers recommendation, in which he said, "the way to get rich is to buy some stock and when it goes up sell it. If it doesn't go up, don't buy it."

Mr. LESHER. I must admit, I have talked to both the economists and the researchers, and in general we have not done a good job in the Department of Agriculture in this area. I think you have got to call it the way you see it, and we're just beginning discussions internally to see how we can get together with the CFTC and the Extension Service to get that job done. We would appreciate any support that Congress is willing to give us in that regard.

Senator **HUDDLESTON**. I haven't had an opportunity to read your entire statement. Does the Department take any position on the so-called users fee?

Mr. **LESHER**. As I understand it, a letter will be coming up to Congress from the administration concerning various aspects of the authorization of the CFTC, including user fees and other issues.

Dawson, at the end of this week, was it?

Mr. **AHALT**. Sometime later on this week.

Mr. **LESHER**. I would just say in general terms——

Senator **HUDDLESTON**. Do you want me to wait for that letter or do you want to tell me now?

Mr. **LESHER**. No. I will give you a general answer, but I would rather not be questioned on it too deeply, because I would rather wait for the letter for that. But the administration does support user fees.

Senator **HUDDLESTON**. Well, we will leave it at that.

Mr. **LESHER**. Yes. I'd appreciate that.

Senator **HUDDLESTON**. That comes as a great surprise.

What about the jurisdictional question, do you have any position on that?

Mr. **LESHER**. We would support the CFTC bill with the kind of division of authority that has been outlined by Chairman Johnson.

Senator **HUDDLESTON**. You agree to it?

Mr. **LESHER**. Yes.

Senator **HUDDLESTON**. Thank you, Mr. Chairman.

Senator **LUGAR**. Thank you, Senator Huddleston.

And thank you, Dr. Lesher, and your associates for coming this morning.

Mr. **LESHER**. We appreciate the opportunity, Mr. Chairman.

[The following letter was subsequently received from Assistant Secretary Lesher in response to a written question from Senator Lugar:]

MARCH 22, 1982.

Hon. RICHARD G. LUGAR,
U.S. Senate,
Washington, D.C.

DEAR SENATOR LUGAR: This letter is in response to a written question you sent me regarding the impact of the CFTC's proposed user fees on market liquidity.

The Department of Agriculture recognizes that any tax or user fee on futures trading will increase costs for hedging agricultural products and tend to reduce market liquidity. However, the user fees proposed by CFTC are very small compared to the value of the products traded. (The proposed fees are 6 cents per contract bought or sold for exchange members or members of the National Futures Association and 12 cents per contract for non-members.) These fees would increase round-turn trading costs by only 0.0024 cents per buchel of grain for members and 0.0048 cents for non-members. We have no sound basis for estimating the effects this would have on market liquidity, but it would likely be small.

Sincerely,

WILLIAM G. LESHER,
Assistant Secretary for Economics.

Senator **LUGAR**. The Chair would now like to call Mr. Howard Stotler, director of the Futures Industry Association.

Mr. **STOTLER**. Thank you, and good morning, Mr. Chairman.

Senator LUGAR. Good morning. We appreciate your coming and please proceed with your testimony.

Mr. STOTLER. Thank you very much for giving us the opportunity to make a presentation before your committee.

Accompanying me this morning is Charles Robinson, vice president of the FIA.

Senator LUGAR. Thank you for coming.

STATEMENT OF HOWARD A. STOTLER, IMMEDIATE PAST CHAIRMAN, FUTURES INDUSTRY ASSOCIATION, INC.

Mr. STOTLER. The FIA is the national trade association of the commodity futures trading industry, with 200 members who handle an estimated 80 percent of all the futures contracts traded by members of the public on U.S. exchanges.

The scope of the futures trading industry is indicated by the record 98.5 million futures contracts traded on U.S. futures exchanges in 1981.

While many stress the spectacular growth in financial futures trading over the past several years, it is important to bear in mind that trading in agricultural commodity futures represents slightly over half the total number of contracts traded in 1981 and except for the record year of 1980, was at an alltime high.

The Futures Industry Association strongly supports the reauthorization of funding for the CFTC in its present form. In addition, we suggest that Congress consider extending the period between reauthorization of the Commission's funding authority to 6 years.

We consider the jurisdictional compromise reached between CFTC Chairman Johnson and SEC Chairman Shad as being acceptable. Although we would draw the lines differently, the compromise represents a division within the range of reasonableness, and it appears to be in the best interest of all concerned not to have two agencies of the Federal Government engaged in a turf battle when the heads of these agencies have worked out a compromise that is acceptable.

With the exception of two limited areas, we have no quarrel with CFTC's proposal to restrict its exclusive jurisdiction to activities involving or concerning transactions on contract markets or those regulated by the Commission concerning options and leverage contracts.

First, the Commission should continue to have exclusive jurisdiction over activities in the United States which involve transactions on the foreign futures markets.

Second, we believe it should be made clear that the granting of a role to the SEC with respect to the formation of commodity pools does not grant such a role to the States and that the States have no jurisdiction to impose State standards on any activities involving commodity pools.

In recent years there have been proposals to vest margin authority over futures trading in either the CFTC, the Federal Reserve Board, or other agencies. Currently, that authority rests with the exchanges.

The FIA believes that the Commodity Exchange Act should not be amended to give the CFTC or any other Federal agency authority over margin requirements for futures contracts. Primary responsibility for margins must remain with the exchanges, who can more closely and quickly monitor the volume and volativity factors of the contracts they know so well and that are traded on their exchanges.

I would like now to address the legislative proposals put forth by the CFTC.

FIA strongly opposes the "user fee" concept as considered by the CFTC. In truth, it is a proposed tax. The so-called user fee is designed to recapture much of the costs of operating the CFTC without regard to any cost benefit analysis. To arrive at a true user fee, one must ascertain who benefits from specific activities and what costs are attributable directly to those benefits.

Furthermore, one must consider what the economic impact of that fee would be. That is, who would end up paying for it and how this charge would change that person's behavior. The CFTC, in considering the user fees, did none of these things.

The so-called user fee, like any tax on commercial activity, is to some extent shiftable. That is especially true for agricultural commodities which facilitate the movement of basic commodities from farmer to the consumer. If a transaction tax is imposed on futures, the ultimate payer may be the farmer, the consumer, or both. But no one has really bothered to find out. We believe it is essential that the economic impact of the tax, the impact on the futures markets, on the direct users of the markets and on the hundreds of thousands who depend on these markets to facilitate the marketing of their production, by price discovery and risk shifting, be thoroughly examined before such a tax is even considered. These markets are not like the stock markets where the only users are the buyers and sellers of the stocks.

While the FIA is opposed to the so-called user fee concept, this does not mean that we are insensitive to the need to reduce Government expenditures. We fully support the National Futures Association, an industry self-regulatory association, licensed by the CFTC, which in the near future, will take over from the Commission many of the activities designed to protect the market users. These are the activities which can be identified as those being done for the benefit of the market users. With the advent of NFA, it would make no sense for the CFTC to impose charges on market users to cover the costs of activities which are scheduled to be taken over by the industry self-regulatory organization in the not too distant future. If the so-called user fees are imposed, there is good reason to believe that NFA will die aborning. Why should the industry pay twice for the same services? It makes more sense to let an industry self-regulatory association assume the functions it is better able to perform and to reduce CFTC expenses as that association gets underway.

While FIA is of the view that the CFTC should continue to have exclusive jurisdiction over activities in the United States which involve transactions on foreign futures markets, we believe its proposal for authority for rulemaking regarding such activity, is much too broad. A more appropriate grant of authority would be achieved by including in the Commodity Exchange Act, the language contained in the present CFTC Regulation 30.02, fraud, in connection with transactions in futures contracts other than on domestic contract markets.

FIA is opposed to the CFTC proposal to "deemphasize the 'agent' category," and to treat persons presently in that category in all respects as associated persons of futures commission merchants.

Ever since there has been futures trading, there have been introducing brokers engaged in soliciting and accepting commodity futures business. Over the years, these introducing brokers have been reported by FCM's to the CFTC as agents and FCM's have been responsible for their acts within the scope of any authority the FCM has given them. Now, the CFTC wishes to eliminate introducing brokers entirely and treat them as though they were employees of the FCM's. This change, especially in light of the CFTC's controlling person proposal, appears to greatly increase the liability of the FCM and its principal officers and partners for the acts of people over which the FCM and its managers have extremely limited control.

FIA strongly opposes the CFTC proposal to amend section 13 of the the Commodity Exchange Act to make the aiding and abetting provisions applicable to judicial as well as to the administrative proceedings and to add a paragraph which would make a controlling person liable as a principal for violations by an associated person, unless the controlling person did not know or in exercise of reasonable care, did not have reason to know of the facts constituting the violation.

Section 13(a) of the act provides that one must act willfully before he can be held as a principal for aiding or abetting the commission of a violation of the act. The proposed paragraph (b) would remove the "willful" standard insofar as "controlling persons" are concerned. For this one class of persons, they could be found guilty of a violation of the act, merely because of simple negligence, merely because they failed in the exercise of reasonable care.

What is the "exercise of reasonable care"? It means different things to different people. CFTC proposes to make human frailty a crime.

We are not suggesting, however, that the customer have no recourse, since the firm employing the offender would still be liable to the customer.

Finally, FIA supports the principles and objectives of the Futures Trading Regulatory Improvements Act of 1982 and the NFA's legislative recommendations.

Thank you very much for your time and attention. I have summarized the written remarks that I have submitted.

Senator LUGAR. Thank you very much, Mr. Stotler. Your entire statement is very interesting and the charts and graphs that you have presented will be made a part of our hearing record.[1]

Would the FIA find a smaller users fee than that proposed by the CFTC acceptable?

Mr. STOTLER. The FIA opposes the user fee concept in its entirety, thinking that the NFA can do the job at less cost than the Government and more efficiently because of industry experience and the self-regulatory mechanism.

---

[1] See p. 518 for the prepared statement of Mr. Stotler.

Senator LUGAR. Why does the FIA recommend a 6-year reauthorization?

Mr. STOTLER. Principally, because it believes the CFTC should be reauthorized and it would be a saving in time and effort on the part of the legislature not to go through this costly reauthorization process again in only 4 years when the standards have been set, which should be well set this time.

Senator LUGAR. You have presumably thought through other options, such as 4 or 8 years?

Mr. STOTLER. Yes.

Senator HUDDLESTON. You figure 6 years is enough for a Senator.

Senator LUGAR. We are looking for something explicit, some guidelines on the length of the reauthorization period.

Why does FIA object to the Commission's proposal for explicit statutory authority over persons in the United States who are offering and selling foreign futures contracts?

Mr. STOTLER. Well, we don't object to that concept.

Senator LUGAR. You don't?

Mr. STOTLER. No; our objection goes to the point that CFTC is seeking absolute unlimited authority over such activities.

Senator LUGAR. Very well.

What problems does the FIA see with the Commission's proposed listing, then, of statutory disqualifications for registration of associated persons?

Mr. STOTLER. I think the problem with that is the clarification of it. I will ask Mr. Robinson to comment on that.

Mr. ROBINSON. The problem there is that the CFTC proposal would make it unlawful for an FCM to allow a person, subject to statutory disqualification, to be associated with the FCM. Yet, the statutory disqualification provision would permit the CFTC to register people who have the statutory disqualifications. So, that the FCM, on one hand, can't permit them to be employed, and yet, on the other hand, the CFTC apparently can register them so they can act in such a capacity.

Senator LUGAR. Could you comment on the CFTC's proposal to require agents of futures commission merchants to be registered as associated persons of the FCM?

Mr. STOTLER. The principal objection is that it would place the total responsibility for an agent—and they really are introducing brokers—on the FCM, when, in effect, they have only limited control. They handle the orders, they handle the accounting, they do not handle the money. And we think that the introducing broker should be registered by the CFTC. And, therefore, that the responsibility would be directed toward that agent on—for their own acts.

Under the CFTC proposal, any employee of an agent, over whom you had no control, could commit a fraudulent act and you would be held responsible. And we feel that we are responsible as a firm for that agency. We would be financially responsible for them, but fraud actions by employees or introducing brokers should be the responsibilty of the employees and the introducing brokers.

If I could give you a case in point, an agent out in Iowa might have someone who took checks addressed to our company—we had one—that made out a check—the check was made out to the FCM, Stotler & Co., the check was fraudulently endorsed and he deposited the money. We had no control over that.

Senator Lugar. Senator Huddleston, do you have any questions?

Senator Huddleston. Just a couple of short ones here.

Mr. Stotler, has your organization made any study as to who the ultimate payer of the user fee might be? You made some suggestions there. Has there been any indepth look at just how that would be handled by the individual traders?

Mr. Stotler. No, no indepth study. It's like—it would be like many transactions, they could very well be paid by——

Senator Huddleston. Everybody is looking to pass it on. That's for sure.

Mr. Stotler. Well, I think it would be passed on in the end, because the Commission structure of the industry is competitive and would be—in effect, one way or another, would be passed on. I think there would be no way that the FCM could absorb it totally without limiting his ability somehow to handle it.

Senator Huddleston. Well, how is the NFA financed now?

Mr. Stotler. The NFA is financed by—in a number of ways, by transaction fees and by assessments based on volume against the exchanges. That is the proposed NFA financing.

Senator Huddleston. You might explain, if you would, just a little bit because I don't understand much about the foreign trading provisions. You object to what is being proposed. How big a problem or how big a volume is there in foreign futures trading?

Mr. Stotler. Futures trading is becoming more international in scope and we are seeing a growth in U.S. activity on foreign exchanges, but I'm not sure of the exact figure.

Senator Huddleston. And your suggestion as to the proposal is what?

Mr. Stotler. Well, we believe that the CFTC should have the control over all exchange traded transactions, both here and overseas, as far as U.S. citizens are concerned.

Senator Huddleston. Thank you.

Senator Lugar. Thank you very much for coming this morning.

Mr. Stotler. Thank you very much.

Senator Lugar. And helping us with these hearings.

The Chair would like to now call a panel: Edmund Schroeder, chairman, Committee on Commodity Regulations, American Bar Association; Thomas A. Russo, chairman of the Committee on Commodities Regulations, Association of the Bar of the City of New York, accompanied by Howard Schneider, Richard E. Nathan, and Richard A. Miller.

Gentlemen, welcome this morning.

Before you commence your testimony, and I will ask you, Mr. Schroeder, to begin, followed by Mr. Russo, the Chair would observe that we will attempt to conclude the hearing at about noon today. We are advised that the Senate comes back into session about 1 or shortly before. This gives us perhaps half an hour for each of the three panels. And the Chair would hope that you might summarize your initial testimony into blocks of 5 to 10 minutes, without being overly rigorous on that. This will leave Senator Huddleston and other Senators who might join us the time to raise questions.

So, if you can gage your remarks within that framework, I would appreciate it.

STATEMENT OF EDMUND SCHROEDER, CHAIRMAN, COMMITTEE ON COMMODITIES REGULATION, AMERICAN BAR ASSOCIATION

Mr. SCHROEDER. My name is Edmund Schroeder and I am appearing here today as chairman of the Committee on Commodities Regulation of the section on corporation, banking, and business law of the American Bar Association.[1]

Just a word about our committee. We have approximately 320 regular members, who are lawyers practicing throughout the country, in both the private and public sectors, and additionally we have about 50 associates who are economists, exchange administrators, academicians, and others who are involved one way or another in the workings of the commodity markets.

Over the past 6 months our committee has been engaged in a study of possible amendments to the Commodity Exchange Act, with a view to clarifying or otherwise improving provisions which we feel are unclear or inconsistent with other provisions, or which do not adequately or effectively implement what we understand to be congressional policy. This is essentially a law reform type of project, Mr. Chairman, and we have tried to avoid the great policy disputes that are going on now, as part of the reauthorization hearings. But it seems to us that while Congress now has the act before it and is considering many of its provisions, it would be useful at the same time to improve it as a statutory enactment.

Annexed to my testimony as exhibit A is a discussion draft containing amendments which the committee has been considering, together with an explanation of such of those amendments whose purpose may not be self-evident. The draft reflects suggestions made by many committee members who contributed to the project. Those suggestions were first developed in subcommittees and were then the subject of extensive discussion by the committee officers and subcommittee chairmen in a series of meetings held in different cities around the country. A list of the officers and subcommittee chairmen is annexed to my testimony as exhibit B.

There has been a tremendous amount of time and effort put into this project, Mr. Chairman, and collectively, I would imagine that the participants have put in over 1,000 man-hours of time. And the project isn't completed yet. We intend to continue after this reauthorization is over to look for further ways to improve the act and ultimately, perhaps, even to come to Congress before the next reauthorization with a proposal to recodify the entire act.

For convenience, I shall refer to the suggested amendments as the committee draft, but I want to point out that they are not officially sponsored or endorsed by the American Bar Association. They are being presented for your consideration as representing the thinking of many of the leading members of the commodities bar regarding ways in which the act could be improved.

Many of the proposed amendments are essentially technical and editorial changes which are designed to make the act easier to read and understand. Others would amend various sections of the act to make their terminology consistent with other sections or to delete redundant or obsolete material.

---

[1] See p. 539 for the prepared statement of Mr. Schroeder.

Now, just to touch quickly on some of the features of these amendments.

First of all, with regard to commodity options: In 1978, as you will recall, Congress adopted section 4c of the act to prohibit sales in the United States of options on commodities that first became regulated in 1975, those are the so-called world commodities, like coffee, sugar, cocoa, and precious metals, and also financial instruments. This provision was designed to protect the American trading public from abusive practices that had occurred in the sale of those options in the United States. However, the language of section 4c has been interpreted by some as forbidding U.S. traders from making unsolicited purchases of options on foreign markets.

On the theory that that was not the intent, that the 1978 ban was not intended to deprive U.S. traders of access to a potentially valuable trading vehicle on legitimate foreign markets, the committee draft proposes amending section 4c to make it clear that it is not unlawful for a U.S. trader to purchase options abroad. Note that the draft would not touch in any way the existing prohibition against purchases or sales, whether or not solicited, of options involving what the draft calls the enumerated commodities, that is to say, those agricultural commodities that have been subject to regulation since before 1975 and which you were discussing earlier today with Dr. Lesher. We take no position on whether that prohibition should be repealed.

The second point in the amendments that is worth noting is that the committee draft would create a new category of commodity professional, called an introducing broker. This category would include any person who is engaged in soliciting or accepting orders for domestic futures contracts but who does not accept margins. Now, under the committee draft, introducing brokers would be required to register with the CFTC and would generally be subject to the same regulatory requirements as are futures commission merchants, except for financial and segregation requirements, since they would not be handling customer funds.

Today, under the law as it presently stands, introducing brokers are sometimes referred to as "agents" of futures commission merchants. But the term "agent" is misleading, because in many cases the futures commission merchant is really the agent of the introducing broker just for clearing purposes, or perhaps there is really no agency relationship at all.

In contrast to the committee draft, section 9 of Senate bill 2109, which embodies the CFTC proposals, would constitute all introducing brokers as agents and require both the introducing brokers an their sales employees to register as associated persons of a partic lar futures commission merchant. The result would be to make the futures commission merchant responsible for compliance with the law by the introducing broker and its staff.

The problem with this approach is that introducing brokers are in many cases independent firms and proprietorships scattered throughout the country. The futures commission merchants with whom they do business frequently cannot exercise anything like the same control over the introducing brokers as they can over their own employees. So, the theory of the committee draft is that these businesses should stand on their own two feet from a regulatory point of view and should be directly responsible for meeting their own obligations. Of course, if in any case the facts show that there is an agency relationship and that the introducing broker is an agent of a futures commission merchant, then that futures commission merchant could be held liable for the acts or omissions of the introducing broker under traditional agency concepts. I cite in my written testimony the decision in a case that was handed down just a few weeks ago, which took exactly that approach.

In the area of commodity pools, the committee draft addresses a number of problems. First of all, the current definition in the statute is defective in several ways. It starts out by defining the term "commodity pool operator," but when you read the definition, what is being described is really the pool and not the operator.

And furthermore, the description that is in the present law is rather obscure in that if you don't know what the definition is getting at, it is pretty hard to figure out what it is that it is attempting to describe. The committee draft would deal with that problem by changing the definition to apply to the pool as opposed to the pool operator and more accurately to describe what it is the pool is doing.

Now, second, the committee draft would require that the regulatory requirements that are appropriate for the pool be applied to the pool and not the operator. And third, related to that is the fact that since the pool is the entity that would be registering, instead of the operator, the committee draft proposes that a new category of registered persons be created called an associated person of the commodity pool operator. Those associated persons would essentially include people who are involved either in sales or in the management of the pool. The CFTC proposal in S. 2109 contains a similar proposal except the CFTC proposal does not go as far. It only relates to the sales personnel. It does not relate to people involved in managing the pool's activity.

In the area of commodity trading advisers, there is a similar proposal the committee draft would make whereby certain individuals associated with commodity trading advisers would be required to register as associated persons.

These requirements would apply to personnel involved in soliciting accounts, but in addition, to people who would be involved in actually rendering the advisory services. Once again, the CFTC has made a similar proposal, but it is narrower. The CFTC proposal only addresses sales personnel, while the committee draft would also apply to persons involved in the advisory process.

With regard to registration, the committee draft would amend a number of the provisions in the act governing the grant, denial, suspension, or revocation of registration of commodity professionals. At present, the applicable provisions are scattered throughout different sections of the act and they are not entirely consistent with one another.

Under the committee draft, all provisions applicable to the registration process would be reorganized and consolidated in a single section. Uniform procedures and standards for denial, suspension, or revocation of registration would be established for all registrants. These procedures and standards contain essentially the substance of what now exists in the law. The committee draft does not propose making any changes in that.

By contrast, the CFTC has proposed, in section 18 of S. 2109, greatly expanding the grounds for denial of registration and what is perhaps more significant increasing the number of categories of instances where registration could be denied without a hearing

The committee does not take a specific position on the CFTC draft other than to say that it raises a number of issues of fairness and due process which, first of all, we are not prepared to testify about here and involves too much detail to go into here, but we do ask that this proposal be very carefully studied before it is enacted in whole or in part.

Finally, the committee draft would add a new section 8a(10) to the act, which would give the CFTC authority to grant exemptions from any of the provisions in the act where that is appropriate. Other agencies, such as the SEC, have similar authority—frankly, I think it was an oversight that this power was not granted to the CFTC back in 1974—and such a provision would give the CFTC needed flexibility in regulating the commodity industry.

Mr. Chairman, the draft that we have submitted here is 40 pages long, much of it single spaced, and there are literally hundreds of changes that are suggested. A lot of thought and work went into these, and I think it would be unfortunate if they did not get consideration in the course of this process. To that end I am prepared to volunteer the services both of myself and the other people who have been active participants in this project to work with you or members of your staff to explore any questions these proposals may raise.

That concludes my testimony, Mr. Chairman. I would be happy to answer any questions you or any of the subcommittee members might have.

Senator LUGAR. Thank you very much, Mr. Schroeder for your testimony and also for your generous offer of assistance, because this is the time in which changes would be made that need to be made, as we approach the markup fairly shortly.

I would like to call on Mr. Russo now to continue and then we will ask for questions from the Senators.

STATEMENTS OF THOMAS A. RUSSO, CHAIRMAN, COMMITTEE ON COMMODITIES REGULATIONS, ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK, AND MEMBERS HOWARD SCHNEIDER, RICHARD E. NATHAN, AND RICHARD A. MILLER

Mr. RUSSO. Mr. Chairman and members of the committee, I want to thank you for giving us the opportunity to present the views of the Committee on Commodities Regulation of the Association of the Bar of the City of New York. My name is Thomas Anthony Russo and I am presently chairman of that committee. I am currently a partner at the law firm of Cadwalader, Wickersham & Taft, and was with the CFTC as Deputy General Counsel and Director of Trading and Markets.[1]

---

[1] See pp. 575–591 for the prepared statements of Mr. Russo, Mr. Schneider, Mr. Nathan, and Mr. Miller.

The Committee on Commodities Regulation of the Association of the Bar of the City of New York, consists of 16 members and in my view, represents a cross section of the commodities bar of the city of New York.

For its 1981–82 project, the committee has been considering three issues that are pertinent to the reauthorization of the CFTC. These issues are: the regulation of commodity pools, the reparations process of the CFTC, and the standard of conduct imposed on commodity industry professionals by the Commodity Exchange Act. We decided to study these issues because we felt that they would not be a primary focus for most of the participants in the reauthorization process and, therefore, might not receive the thoughtful consideration we believe they merit.

In conjunction with this project, we divided the committee into three subcommittees. The subcommittee studying commodity pools was chaired by Howard Schneider, to my right, who is a senior partner at the law firm of Rosenman, Colin, Freund, Lewis & Cohen, and the first General Counsel of CFTC. The subcommittee considering the standard of conduct was chaired by Richard Nathan, who is a partner of the law firm of Marshall, Bratter, Greene, Allison & Tucker. Mr. Nathan was Deputy General Counsel of the CFTC and, subsequent to Mr. Schneider's departure from the CFTC, served as Acting General Counsel. Finally, the subcommittee studying the reparations process was chaired by Charles Nastro, executive vice president and counsel to the commodity division of Shearson/American Express. He is not here and Richard Miller, who is an attorney in private pratice in New York and also editor of the Commodities Law Letter, will be giving his presentation.

Each subcommittee chairman will present the views of his subcommittee. I might add that there is also a report which we are finishing which has taken many hundreds of hours of the committee's time in hopes that we would add to the reauthorization process.

The first speaker will be subcommittee chairman, Howard Schneider.

Mr. SCHNEIDER. Mr. Chairman, thank you for the opportunity to be here today.

I would like to raise two specific points in connection with reauthorization and its implications in the commodity pool area.

First, Congress should explicitly reiterate, preferably by a statutory provision, CFTC preemption of all State regulation of commodity pools.

And second, Congress should make clear, possibly by a statement in the Congressional Record, that so long as commodity pools and their advisers deal in and with futures contracts and options on futures contracts, whatever the characterization of the underlying commodity which is traded, that is, whether regarded by the SEC as a security or not, the Investment Company Act of 1940 and the Investment Advisers Act of 1940 are inapplicable.

As background in connection with the State regulation area, notwithstanding explicit congressional statements in 1974 and 1978 to the effect that unnecessary and duplicative regulation in the commodity area was to be avoided and that State regulation of the commodity industry was preempted, State securities administrators have insisted on qualification of commodity pools under the blue-sky laws of the various jurisdictions. Moreover, many State regulators have imposed substantive regulation on commodity pools which, at times, conflict with CFTC regulations or reverse positions which the CFTC specifically considered and rejected. Additional even more burdensome regulations, dealing primarily with ratesetting compensation issues which would have the effect of drastically changing commodity pools and perhaps even eliminating them as viable entities, have been proposed by the North American Securities Administrators Association.

The practical effect of State regulation in this area has been to increase the cost of preparing an SEC registered public pool by approximately $30,000 to $50,000, or about 20 percent of the anticipated cost. Since the prospectus is carefully reviewed by both the SEC and CFTC and since there have been virtually no claims of abuses in this area, the State's entry into the field is a clear case of regulation for regulation's sake, without any corresponding appreciable benefit to the investing public. Moreover, certain States, such as Texas and South Carolina, have simply refused to permit the qualification of commodity pools in their States and have, therefore, deprived the citizens of their States of the availability of this investment vehicle which the Congress has explicitly sanctioned.

The CFTC/SEC proposed amendment to the Commodity Exchange Act, at section 4m(2) makes explicit the extent of the SEC's continuing jurisdiction. We have no quarrel with that provision as it affects the SEC. What the provision does not do, however, is make explicit that State regulation of commodity pools is preempted. That is the clear intent of the two agencies.

Given the unfortunate history of State insistence on substantive regulation in connection with commodity pools, despite clear congressional expressions to the contrary, it is my belief that the only solution to the problem of State duplicativeness and unnecessary regulation of the area would be to further amend section 4m(2) and make explicit CFTC preemption of State regulation.

As background to the question of the 1940 acts' inapplicability, the SEC has consistently taken the position that where the underlying commodity to which a futures contract relates is itself a security, even if an exempt security, then the futures contract is a security which would, if sufficient trading in such financial futures occurred, require registration of a commodity pool as an investment company under the Investment Company Act of 1940 and of its adviser as an investment adviser under the Investment Advisers Act of 1940.

Fortunately, the SEC retreated somewhat from that position in a no-action letter issued in 1979. Based on that no-action letter, commodity pools and their advisers, as a practical matter, have operated without registration under the 1940 acts. The jurisdictional accord between the CFTC and the SEC should reinforce the concept of the nonapplicability of the 1940 acts to commodity pools and their advisers.

However, at the end of the SEC/CFTC joint statement in presenting their legislative proposal to Congress, the following sentence appears: "Moreover, in appropriate circumstances, commodity pools and persons managing them may be subject to the Investment Advisers Act of 1940 and, if a pool conducts not only a commodities business but also acts as an investment company, the Investment Company Act of 1940."

That seemingly innocuous sentence may inadvertently serve to permit a reintroduction of the theory that the 1940 acts are somehow applicable to commodity pools and their advisers if they were to deal in financial futures contracts or options on financial futures contracts. I believe that the intent of the sentence and, indeed, the whole tenor of the CFTC/SEC accord to be that the CFTC's exclusive jurisdiction includes futures contracts of any type and options on futures contracts of any type, and that the SEC would not take or assert jurisdiction in these areas. Thus, a commodity pool and its adviser would continue to remain exempt from registration under the 1940 acts, as well as the applicability of the 1940 act, if they dealt in futures contracts and/or options on futures contracts of any sort. It is only when the commodity pool and its advisers cross the line and invest—in more than a de minimus way—in actual securities or options on securities which are traded on a national securities exchange that the 1940 acts may apply. I assume that these are the appropriate circumstances referred to in the sentence quoted from the joint statement.

So as to avoid any ambiguity, I would urge that a statement be placed in the Congressional Record which would make clear that, notwithstanding the last sentence of the joint statement, so long as commodity pools and their advisers deal in and with futures contracts and options on futures contracts, whatever the characterization of the underlying commodity which is traded, that is, whether deemed to be a security or not, the 1940 acts are not applicable. Furthermore, Congress should direct the CFTC and the SEC to set a clear standard of how much activity in the securities markets will require registration by a commodity pool and its advisers under the applicable 1940 acts, that is, what is more than a de minimus securities investment type activity.

Thank you, Mr. Chairman.

Senator **Lugar**. Thank you, sir.

Mr. **Schneider**. Dick Nathan has a very short statement.

Mr. **Nathan**. In deference to the committee's concern as to time, I will try to be very brief.

My subcommittee considered the standards of conduct that the Commodity Exchange Act imposes upon industry professionals, particularly with respect to the anti-fraud provisions. We have found that the provisions are extremely broad and uncertain of application, at least as the CFTC has sought to enforce them.

What is fundamentally at issue is whether an industry professional should be subject to the risk possibly of loss of livelihood or other severe administrative sanctions based on nothing more than mere negligence or inadvertence, or whether the consequences of that kind ought to flow only upon proof of conscious wrongdoing. This is particularly important in light of the increasing blurring of the distinctions between the securities area and the commodities area, so that an industry professional offering two substantially similar products might nevertheless find themselves subject to vastly different standards of conduct and sanctions, depending on which act a particular product is subject to.

Let me just put this in focus for a moment. Section 4b of the act, which deals with futures commission merchants, prohibits cheating and defrauding, attempts to cheat, attempts to defraud and other willful behavior. Nevertheless, a court of appeals, while recognizing the proof of a violation requires knowledge of wrongdoing, has held that someone could violate this provision by carelessly ignoring the truth, endorsing a carelessness standard.

The provision relating to commodity options was patterned after 4b, but the word willful was consciously left out by the Commission. And 4o, which applies to pool operators and trading advisors, has been subject to equally expansive interpretation. The courts ruled that this may be violated without proof of an awareness that conduct might deceive or defraud.

Of course, the unfair and unreasonable standard that the Commission has sought to apply under each of these provisions is a far cry from the Supreme Court's ruling under rule 10b–5 in the Securities Exchange Act. The Supreme Court has said scienter must be alleged and proven, and as a result, the courts have held that no less than reckless behavior or an extreme departure from the standards of ordinary care is required to be shown.

In these circumstances, our committee respectfully suggests that the Commodity Exchange Act be amended expressly to limit application of these anti-fraud provisions to conscious wrongdoing or to reckless conduct. At the very least it should be made clear on the record of these hearings that no person or firm in the industry should be subject to severe administrative sanctions based upon inadvertence or carelessness or even substantial negligence.

Thank you, Mr. Chairman.

Senator LUGAR. Thank you.

Mr. MILLER. Mr. Chairman, thank you for the opportunity to present our views. I, too, will try to be brief as possible.

My comments are addressed to the reparations process presently embodied in section 14 of the act.

When it was created in 1974, reparations was envisioned by Congress as similar to a small claims court proceeding, so as to be able to provide expedited redress to customers.

Today, however, reparations is not as speedy, nor as inexpensive or protective of the rights of the general public, as it was originally intended. Indeed, it has become a financial white elephant that has siphoned much needed funds and personnel away from the primary duties of the CFTC.

However, there are considerations that lead us to believe that reparations should be retained despite the existing problems. Namely, its due process advantages, including the opportunity for CFTC and judicial review of reparations decisions.

Before addressing the amendments that we will recommend to Congress, I would just mention that our study included a review of proceedings that could stand as alternatives to reparations. Namely, civil litigation and arbitration proceedings. And we weighed the cost and benefit of each of these against reparations.

We concluded that civil litigation fails as an alternative forum to reparations for a number of reasons relating to the jurisdictional procedural complexities of civil litigation.

With respect to arbitration, we feel strongly that it should some day supersede reparations, particularly for smaller cases. But the time is not yet at hand for the arbitration process and the commodities arena has not yet reached a level of maturity that would permit immediate suspension of reparations in favor of arbitration.

Thus, to improve reparations, we suggest the adoption of certain attributes of arbitration practice in general for all reparations proceedings. And we commend to Congress a two-tier approach to reparations in the future.

Briefly, the division would be at the jurisdictional amount of Federal court, that is $10,000. So that reparations would be retained, but only in a setting that would amount to a CFTC administrative arbitration forum. In this manner Congress would permit no oral hearing nor discovery, no findings of fact, or legal opinions, and no rights of appeal in the smaller cases.

We envision that this first tier process would itself cease to function upon the initiation of the National Futures Association arbitration forum, which would be given jurisdiction over these small claims.

If adopted, our recommendation would give cost savings for the Commission, the commodity industry, and most importantly to the customers and it would assure more rapid redress of their grievances.

The second tier would be for cases over $10,000 and it would be the same fashion as reparations is today.

In addition, we would recommend some technical amendments to the act to take into effect a couple of problems that we dealt with.

First, we would exclude from reparations jurisdiction entirely those respondents who are in bankruptcy or receivership. It seems to us that bankruptcy courts would be the best place to resolve those problems.

Second, we would suggest a technical amendment to the statute of limitations to solve interpretation problems.

Third and fourth, we would impose specific statutory deadlines on the Commission to undergo the screening process relating to complaints and discussions. There are presently no such statutory time limits and these areas have been the source of some delay in the past.

In conclusion, we note that the CFTC, in its submitted legislative proposals has not addressed any of the widely perceived problems that we see in reparations which have created the current reparations quagmire. Rather, the CFTC has responded with a proposal that asks you to simply cede Congress' authority and control over the reparations process to the Commission's absolute discretion. We strongly urge you to reject the Commission's legislative proposal.

It may be that the reparations process has become unworkable. For sure, it is a far cry from what Congress originally envisioned. However, we recommend that reparations be retained because of the strengths embodied in the statutory due process which Congress enacted in 1974. We believe that the Commission's proposed legislation would, in effect, sever reparations from its statutory underpinnings, and sap its present strength and destroy its potential for constructive future growth.

Thank you, Mr. Chairman.

Senator **Lugar**. Thank you, gentlemen.

I would say at the outset that the committee deeply appreciates the tremendous amount of work that both of your groups have done in this area, work which is certainly timely. And there are a great number of questions that I'm certain Senators and the staff will want to ask as they become more thoroughly acquainted with all the elements of your testimony.

In this short period, however, I would like to raise a few questions for the record.

Mr. Schroeder, why do you recommend different registration requirements for commodity pools and trading advisors, and for the persons who manage the pool and advisory services?

Mr. **Schroeder**. Mr. Chairman, right now there is no provision in the act that specifically requires the individuals that are involved in the activities of the commodity pools and the commodity trading advisors to register. The CFTC has proposed that the individuals that are involved in the sales activities of the pools and in soliciting business for the advisors be registered. In the view of our committee, the public interest would be served and public protection would be enhanced if the registration requirement also applied to individuals who are involved in managing the activity, the investment activities of the pool and the advisory services of the commodity trading advisor, since the public investor has as much at stake in what they do after their business has been solicited as they do in the solicitation of the business in the first place.

Of course, registration as it is now conducted is really no insurance as to the competence of the individuals, but gives some assurance as to their honesty. Basically, registration is granted on the basis of background checks done by the FBI as to prior convictions and other difficulties that the applicant may have been involved in.

At some point, under other proposals that are around not being made by our committee, Section 4p of the act may be amended to provide also some measure of competency standard for these individuals.

Senator **Lugar**. Clearly, the reason why all of this arises is that the subcommittee has heard testimony from time to time of loose practices, somewhat far afield, but I think much of the testimony has quite correctly centered upon who ought to be liable, each State along the way should be responsible and we have had some luring distinctions in terms of "on-market," "off-market" activities, activities far removed, but one of the purposes of all of this hearing and the redrafting is to bring some confidence to the ordinary consumer out there, that some somebody is responsible, as opposed to a whole set of defenses in which persons are found not to be responsible.

I think each of you gentlemen, as attorneys, understand that problem all too well, both in terms of clients as well as in terms of public policy. And this is why the drafting of this particular area is of particular concern. It is almost a fine point in which many persons who do not understand the whole CFTC to begin with would mind boggle at trying to get into all the distinctions. But clearly because we are talking about reputations, firms, livelihood and so forth, this is extremely important.

Mr. SCHROEDER. Right, and we feel that our proposals for the registration of these individuals will be a step in the direction that you described.

Mr. RUSSO. I just wanted to add that I thought the CFTC proposal was very good. Part of the problem has been in the off-exchange area, which the CFTC has divided into two separate areas, with one area, for example of dealer options, where there have been no problems, and certain leverage contracts going to the CFTC and the rest going, I think, to the States. One part of the problem is a lot of the off-exchange dealers are claiming to be under the CFTC's jurisdiction and trying to oust the States. At least the CFTC proposal deals very directly with that problem. I think that's a very significant problem which seems to be giving those off-exchange instruments, with the exception of dealer options, a black eye.

Senator LUGAR. Mr. Schroeder, does your committee believe that the CFTC should have the authority to grant exemptions from every section of the Commodity Exchange Act, or are there certain sections in which you would reserve that exemption provision?

Mr. SCHROEDER. The proposal that we have made, Senator, would grant the CFTC the authority to exempt persons and transactions, or classes of persons and transactions, from any provision of the act, to the extent that the CFTC finds that such exemption is not contrary to the public interest and is consistent with the purposes intended by the act.

I think there are certain sections of the act in which it is very difficult to conceive of circumstances under which an exemption would be appropriate, such as, for example, an antifraud provision. However, our feeling is that the CFTC should be granted the discretion to make those decisions and presumably would never grant an exemption in a case such as an antifraud section where it was just inappropriate to do so.

Senator LUGAR. I have some questions on reparations. I suppose I should direct these directly to you, Mr. Miller, since you testified on this issue.

To what extent do the Commission's proposed changes in the reparations program coincide with your proposals for handling reparations and complaints under $10,000?

Mr. MILLER. Well, in general terms the Commission's proposal, in essence, asks that it establish its own internalized procedures. I don't know what they are going to do with their own internalized procedures.

There is a second point that may be overlooked in all this. That is that the Commission would only impose its reparations jurisdiction under their legislative proposals on persons who are registered with the Commission.

At the present time the way the ALJ's have interpreted the act, they have extended the reach of reparations to those persons who are actually registered, as well as those who should be registered.

I think that is an important extension, because it brings into reparations those persons who have avoided registration for one reason or another, and the ALJ's have properly reached out and brought them under the act. For some reason—I'm not sure what the reasoning is—the Commission has asked Congress to amend it to exclude that second long-arm reach and only have jurisdiction on reparations imposed upon those actually registered.

Now, we oppose that and we oppose the actual delegation by Congress to the Commission of all the rules and regulations that would govern reparations, even below $10,000. It should be streamlined, but I don't think it should go carte blanche to the Commission.

Mr. RUSSO. Mr. Chairman, when we did the study on reparations, we went through many, many, many reparations cases. We went through the process—a lot of us had had firsthand experience in that area. We initially decided that we were going to oppose reparations, and we changed our mind after looking at the system and looking at the alternatives. It would have been easy to accept the Commission's view, because it does recognize there are problems which the CFTC will deal with. But we didn't think that was enough. That is why we decided in the report to look at where the problems really were and try to deal with them in specific terms.

There are lots of reparations matters involving bankrupt practices where the people don't get any money at all. These cases are a waste of time and we decided to cut those out and we decided to make other recommendations to streamline the process. We tried to be much more specific than the Commission.

Obviously, the Commission could take what we have done and ultimately adopt our recommendations. But we tried to be a little more detailed.

Senator LUGAR. Well, why are you requiring bankruptcy to be a statutory rather than a regulatory exemption from reparations proceedings?

Mr. MILLER. Well, it may very well be that this could be handled by regulation, but in view of what the Commission was proposing in its statutory scheme, we thought it belonged in the statute so it would be absolutely clear.

Your question—let me address the second part of your question, and that is why do we propose it. That is for streamlining purposes. There are—I forget the exact numbers, but if you look at the dollar amounts that have been awarded in reparations and the dollar amounts that have actually been collected, there is a vast spread of dollars.

One of the reasons for that is because the reparations process has worked in giving justice to complainants whose respondents in the cases were either bankrupt or in receivership, they didn't have the money. That clogged up the process for people who had valid claims against existing deep-pocketed respondents and with their valid claims they should get their day of justice sooner than later.

There is an alternative forum for persons with claims against respondents in receivership or bankruptcy. That is the bankruptcy courts and that is what they are there for. On cost-benefit analysis, we would be far ahead of the game if these matters were resolved in bankruptcy proceedings.

Tom, do you have anything?

Mr. RUSSO. No, I was just going to say, obviously, that it could be clarified in the statute in the amendments to section 14 that the Commission may in its discretion exclude these people. And again, we were not into discretion, we were into trying to solve the problem. And that is probably why we did what we did, Mr. Chairman.

Senator LUGAR. Mr. Schroeder, have you had the opportunity to discuss your statement and draft proposals with Chairman Johnson, and if so, what was his reaction or that of other members of the Commission? Has there been any melding of ideas in connection with this draft?

Mr. SCHROEDER. No, sir. The members of the committee that have worked on the draft include staff members of the CFTC. Now, of course, when they act upon something like this, they're acting in their individual capacities and in no way officially bind the Commission. But the fact is there has been input from, and in fact some very excellent work was done by, some CFTC staff members on some of the amendments that are contained in here. And the draft has been circulated in the form, virtually the form that you have seen it today—it has been circulated to the entire committee, including the CFTC staff. And we, of course, welcome any comments that they may have and we're prepared to enter into dialog with the Commission staff through the markup process to find out what, if any, problems they have with what we have suggested and to try to reconcile any differences in approach.

Senator LUGAR. But thus far Chairman Johnson has not been involved?

Mr. SCHROEDER. Has not made any official statement.

Senator LUGAR. Would that be true for you, too, Mr. Russo, and your associates?

Mr. RUSSO. That is true, and I would think that in certain areas, certainly reparations, that he may not be in total agreement.

Senator LUGAR. Senator Hayakawa, do you have questions of these witnesses?

Senator HAYAKAWA. Yes.

Mr. Schroeder, you suggest the creation of a new category of commodity professional called the introducing broker. And would this action either leave the CFTC with greater regulatory burden or end up costing the Commission more money?

Mr. SCHROEDER. Our perception is that it wouldn't change the regulatory burden at all. What it would do is, it would take the introducing broker and make him directly responsible to the Commission for his compliance and the compliance of his sales personnel with the law. That would be in contrast to the CFTC approach, where the CFTC would, in effect, be looking to the futures commission merchant in some way to be responsible. I don't think the CFTC approach will contemplate relieving the introducing broker of responsibility, but they would have, in effect, a backup source of liability, namely, the futures commission merchant to look to.

We have not attempted to make any kind of a manpower assessment or anything, but I believe—our feeling is that it really would not significantly change the regulatory burden on the Commission one way or the other.

Senator HAYAKAWA. Thank you.

The members of this subcommittee have heard quite a bit of discussion of the so-called "user fee." I would like to invite any of the witnesses who have a strong view on the subject to give an answer, if they will.

Mr. **Schroeder**. Senator, our committee did not discuss that question at all. We were strictly looking into the law reform aspects of amending the act, and none of these great policy controversies, so I am not in a position to make any comments at all on it.

Senator **Hayakawa**. Do any of you have private opinions on this matter that you would like to put into the record?

Mr. **Russo**. Our committee did not look at it. If I were in the shoes of this committee, it seems that there has been a great deal of pressure to have a user's fee and certainly there is enormous industry opposition. It's the one thing that has solidified this industry. I would think that, because of this seemingly critical reality, there should be some alternative, perhaps a moratorium.

Another alternative would be simply to charge the exchanges for various services that the CFTC performs. I say that because when in my days at the CFTC, some exchanges would make submissions to the Commission, an enormous amount of staff time would be spent on those submissions because the exchanges had not spent the time themselves. And as somebody who managed people's time there, I was resentful of that. Some exchanges did a first rate job on their submissions and very little staff time was spent.

There should be a way, just as we lawyers have time charges, to have some way to tax that. Exchanges will get that money back through volume.

Also, the CFTC does raise a great deal of money in terms of fines. It has raised some rather significant amounts in recent settlements. And I think that could also be added. I think the bottom line is one way or another, enough money could be raised with these kinds of charges for the CFTC to come close to supporting itself, and there probably are alternative ways to go about this. And it may make some sense to put the burden on the CFTC to come back with some alternative ways that may make more sense. The user's fee is not acceptable to the industry, but it doesn't mean it's not right. It just means that there are two bodies who want something and they are so far apart that there have to be compromises.

What I would suggest, if the NFA argument for a moratorium is attractive, is that pursuant to a moratorium, the NFA as a self-regulatory organization be placed under pressure to do everything it says it's going to do with a clear understanding that if the NFA fails to accomplish all its objectives, we are going to have user's fees and that's the end of it.

That, to me, is a logical alternative. Maybe coupled with charging the exchanges for work that the CFTC does, together with fines. There has got to be some way to come to a compromise here.

Mr. **Nathan**. The last point that Tom made, I think, is the most important, that is that we have evidence of the industry's willingness to police itself and to assume the financial burden substantially for doing so. The necessity for this additional financial burden at this time and in this context is not readily apparent.

I think it's also important to realize that the user's fee is a euphemism for a transaction tax. This has nothing to do with user's fees as that term is normally used in the Government where a fee is imposed for a benefit directly conferred upon the person paying the fee.

There may be some merit consistent with what Tom was saying for the Commission considering the charges it makes for registration processes and other things to see whether its expenses in connection with those processes are met by the fees it charges. That would be a true user's fee and maybe make some sense.

Mr. RUSSO. If I might say, that, together with the brief moratorium, would be an enormous incentive for the NFA to do everything it has promised. I worry that there will be both very high user's fees and more justification for a larger CFTC. So, maybe the combination does make sense.

Senator LUGAR. Let me follow Senator Hayakawa's question with the general problem that we have had in discussing this user fee or an alternative, as presented by the industry.

I suppose at the center is a philosophical question—to what extent should all the people of the United States of America pay taxes to support the CFTC? Now, the industry has implied and some witnesses have testified that there are general goods that accrue to all citizens in this country, and that in terms of futures markets these are providing hedging opportunities and the price finding mechanism. There are a number of ways that futures markets facilitate commerce in the country, although very few persons in our country are involved in this operation. There are some general benefits of futures markets, and I gather that most of us would grant that.

The problem is attempting on some spectrum to determine how much benefit. And if not very much, and the cost ought to be borne by the industry it benefits and those who use the services, then how that is to be done. I think you have drawn the correct conclusions that conceivably a transaction tax, a user tax, by contract, may not be the appropriate way, but in terms of the volume of money to be raised, it appears to be by far the most expeditious way.

As we look at all of these new contracts coming in, from the view of charging fees, we are talking about very small sums of money in comparison with the total budget of the CFTC. So, these arguments have not been totally persuasive if one is taking a look at the overall revenue picture of the Commission. And I suppose we have a problem, in which the NFA in a sense is being held hostage, in having a user tax or transaction tax. The thought is presented by many in the industry that if we were to proceed in that way, then the NFA is done, and by and large we can simply have a big CFTC and a bigger budget and more Government control, things that would—I think the industry's pick would be objectionable to us. It might very well be. Senator Hayakawa and I are not advocates of enlarged bureaucracy and larger Government, and we would really like to see the other trend. But we have come to a important polarization in this question. This is why we press, even the five of you who are consciously sworn not to get into these high policy issues, to delve into them, as experts who have had something to say about such issues in the past.

Mr. RUSSO. Well, I must say if they had time charges at the rate of Wall Street lawyers, you probably could fund the deficit.

Senator LUGAR. We're grateful to you for coming this morning with your testimony.

Thank you very much.

The Chair would like to now call on a panel of John Conheeney, chairman of Merrill Lynch Commodities, New York, David Johnston, senior vice president of E. F. Hutton in New York, and Harold Heinold, chairman of the board of Heinold Commodities, Inc., Kouts, Ind.

Senator LUGAR. Gentlemen, I appreciate your coming this morning. To the extent that you can summarize your testimony in a 5-minute period, more or less, and then proceed with questions for additional periods, we would appreciate it.

I will call upon Mr. Conheeney first of all.

STATEMENT OF JOHN J. CONHEENEY, CHAIRMAN OF MERRILL LYNCH COMMODITIES, NEW YORK, N.Y.

Mr. CONHEENEY. Thank you, Mr. Chairman.

My name is John J. Conheeney, and I'm chairman of Merrill Lynch Commodities, Inc., which is a wholly owned subsidiary of Merrill Lynch, Pierce, Fenner & Smith. I am also a member of the board of directors of the Chicago Mercantile Exchange and have previously served on the board of governors of the Chicago Board of Trade and the Commodity Exchange, Inc. I'm currently the chairman of the Futures Industry Association, provisional director of the National Futures Association, and I have been in the commodity business for over 29 years.[1]

Merrill Lynch conducts business as a futures commission merchant on behalf of its public customers on all U.S. contracts markets and on all of the world's major commodity exchanges. I am, therefore, pleased to have this opportunity to offer the views of Merrill Lynch on the reauthorization of the Commodity Futures Trading Commission, and amendments to the Commodity Exchange Act that have been proposed by the CFTC.

I should first state that Merrill Lynch supports the CFTC's continued role in regulating the commodities futures industry. Although we have occasionally disagreed with particular regulatory actions by the CFTC, it has provided needed protection to the public. It has been our policeman on the block and the agency which assures that the Nation's commodity markets fulfill their important economic functions. We, therefore, recommend the reauthorization of the CFTC and the continuation of its jurisdiction over the commodity futures industry.

There are, however, particular aspects of the CFTC's proposed legislation to which we object. For example, the CFTC proposes to impose liability on controlling persons for the conduct of those they are asserted to control. This concept, however, would have the undesirable effect of exposing parent companies, their shareholders and their customers to liability arising from the totally separate operations of their commodity subsidiaries. Moreover, such controlling person liability is unnecessary because the Commodity Exchange Act already contains broad provisions that impose liability on aiders and abettors of illegal activities, and it specifically imposes liability on principals for the activities of their agents under the doctrine of repondeat superior.

---

[1] See p. 592 for the prepared statement of Mr. Conheeney.

The CFTC also proposes to eliminate the existing practice that allows small firms or individuals that introduce customers to register as agents of the clearing futures commission merchants. The CFTC proposal would effectively remove those firms and individuals from the industry. Such a result would be anticompetitive. It would also conflict with current efforts to deregulate our economy and to eliminate regulatory barriers that unnecessarily hinder small business enterprises.

The CFTC has further proposed the adoption of a so-called user fee to pay for all or much of its budget. We believe, however, that this term is a misnomer because it implies that the only persons benefitting from commodity futures markets are the direct participants. This is not the case. Although the user fee would be paid by those persons trading commodity futures contracts, they are not the only beneficiaries of CFTC regulation. The American public benefits from the price stability resulting from hedging on commodity exchanges, and it is the American economy that benefits from the price discovery that these markets provide.

The CFTC has also proposed that State and Federal regulators pursue an aggressive approach toward the fraudulent activities of persons selling commodity related instruments that are not traded on or subject to the rules of a contract market. We believe that this proposal is necessary, since most enforcement problems are caused by such off exchange instruments.

We do object, however, to the imposition of State regulatory authority over contracts traded on foreign exchanges. Commodity trading, of necessity, transcends national boundaries, and many of the commodities traded on U.S. markets are world commodities that are affected by international as well as domestic factors. Trading on foreign markets in such commodities is integrally related to the price discovery and effective operation of their counterpart, contract markets in the United States. In order for these markets to maintain their international scope, they cannot operate under inconsistent regulations by the States. Such a situation would severely hinder international businesses that rely on these world markets to hedge and to trade. Moreover, because issues involving foreign exchanges touch upon the foreign relations of the United States, an area of exclusively Federal concern, those instruments should be regulated solely by the CFTC, the Federal agent that now has responsibility for regulating trading in those instruments in the United States.

Finally, Merrill Lynch believes that the SEC and the CFTC's jurisdiction over the regulation of commodity pools should be clarified to limit the SEC's role solely to the regulation of capital formation activities, that is, the offer and sale of securities to pool participants. Moreover, the CFTC should be given exclusive jurisdiction over all other activities of commodity pool operators, and it should be stated explicitly that the States are preempted from regulation of pools. Currently two States have enacted regulations prohibiting the offering of SEC registered pools. This approach would avoid conflicting regulatory requirements that may be imposed by the several States and the SEC.

In the statement I have filed with the subcommittee I have detailed more fully our position on these issues. I urge that you consider it in deliberations.

Thank you, Mr. Chairman, and we would be pleased to respond to any questions that you might have.

Senator LUGAR. Thank you, Mr. Conheeney for your opening statement and likewise the balance of your testimony, which goes into detail on these points. It will all be made a part of the hearing record.

Mr. Johnston.

STATEMENT OF DAVID T. JOHNSTON, SENIOR VICE PRESIDENT, E. F. HUTTON, NEW YORK, N.Y.

Mr. JOHNSTON. Thank you for the opportunity to be here.

My name is David Johnston. I am appearing today on behalf of E. F. Hutton, where I am senior vice president and a member of the board of directors. I am also chairman of the Commodity Exchange, better known as COMEX, a member of the board and former chairman of the Futures Industry Association, and a member of the organizing board and vice president of the National Futures Association.

I am here today to recommend reauthorization of the Commodity Futures Trading Commission as the sole Government agency with authority to regulate business transacted on regulated futures exchanges.

Since the inception of the CFTC I have always looked at reauthorization not only as an opportunity to fine tune existing legislation, but more importantly as an opportunity to review the overall regulatory structure of the industry to make certain that regulations are as efficient, effective, and fair as possible.

Further, that the quality of regulation should be such that it enhances the image of the industry, not only with the users of the markets but with the public, the press and Congress, as well.

Industry image is as important to all these as it is to a brokerage firm such as E. F. Hutton in its attempts to do business with the public. And we all know that in the years to come we can do without the type of adverse publicity we as an industry have received in the past 10 years.

I am hopeful that this reauthorization process will provide a clearly defined regulatory structure which will be effective and can endure through time. This may seem impossible because of the changes and progress made by this industry in recent years, however, the industry is not as complex as it seems. When it comes down to basics there has been little change in the way markets are traded, little change in the basic market function that the industry provides, and little change in the basic structure of the markets themselves. The risk shifting and price discovery functions of each market are the same regardless of the underlying asset, whether it be agricultural, mineral or financial. Therefore, except for contract details, there is little to distinguish one from the other from a regulatory standpoint. Moreover, despite the substantial growth in the size and number of markets, it would appear that there are still substantially less than 200,000 traders with positions in all markets at one time.

The net result is an industry where all segments can operate under common rules and provide similar services or functions. Therefore, it would be inefficient and costly for regulation by several Government agencies. In my opinion it would be a major error to permit regulation of the industry or any part of it by any Government agency whose claim for regulatory turf is based on their responsibility to regulate the underlying assets.

Up until the mid-1970's the industry was regulated by the exchanges with the CEA having oversight. However, the CEA was excluded by the act from regulating certain commodities. The Commodity Futures Trading Commission Act of 1974 brought all futures trading in the United States under regulation by exchanges who had clear responsibility for the regulation of their members, with the new CFTC having oversight. Unfortunately, the advent of negotiated commissions, as well as major expansion in trading of off exchange items, such as options, resulted in a substantial increase in firms who did not need to be members of any exchange in order to do business. Since they were not members of any exchange, they did not come under the regulatory umbrella, and the new CFTC had neither the resources nor the personnel to do the job itself. The industry, in response to this problem, set to work to initiate a title III organization to bring under direct industry regulation those nonmember elements doing business with the public. The title III organization was to be formed to regulate FCM's who are not members of exchanges, as well as others, such as commodity pool operators, commodity trading advisors, option dealers, et cetera, leaving it to the exchanges to regulate their membership as in the past. However, provision was made to permit exchanges to shift responsibilities for regulating member FCM's to the new title III organization to eliminate multiple regulation of those doing business with the public. This was the start of the National Futures Association.

The NFA had a difficult time getting started because of the number of early roadblocks, but has recently been approved by the CFTC and, as Leo Melamed has recently testified, it is in the process of preparing the organization to do an effective job.

Accordingly, assuming the NFA becomes operational, the industry would be regulated entirely by self-regulatory organizations. The exchanges would be responsible for exchange matters, such as contract details, trading rules, margins, financial integrity of clearing houses, et cetera, while the NFA would regulate the activities of those doing business directly with the public.

In my opinion, and I said this in the reauthorization hearings in 1978, that portion of the industry doing business with the public needs to be regulated by one entity under one set of rules and regulations. Either the CFTC should become much larger in size and become involved with direct regulations, or the regulatory functions should be performed by the industry. Since the industry has sought to do this, wants to do the job, and wants to pay for it, I think it would be wrong, particularly in view of the present policies of the administration concerning deregulation and cost reduction, to do otherwise.

However, I would hope that the CFTC would not get involved in direct regulations as opposed to oversight for several reasons. First, I agree with the policies of the present administration that the regulatory functions of the Government should be reduced and turned over to industry wherever possible.

Second, and more important, I believe that the CFTC can do a much more effective job if its work is limited to oversight. I believe that the mere presence of the CFTC in an oversight capacity has helped the industry and has caused all exchanges to improve their regulatory processes. Constructive oversight, coupled with the industry experience on the board of exchanges, as well as the new NFA, should provide the most effective and efficient industry regulation possible at the cheapest cost. The resultant savings at the CFTC level should be substantial.

The NFA, however, is not operational as yet. Plans call for a fast startup and much work has already been done. The recent proposal of a users fee came as a shock since it quickly became clear that much of the industry would not support an industry regulatory body if there was the danger that it would eventually be in competition with a Government agency. At the present time industry support for an NFA is at the highest level since its inception. I believe this would be the wrong time to change that situation.

I hope that this committee will see fit to provide legislation whereby the NFA can become operational with the provision that Congress review over the next 3 or 4 years the progress of the organization, and the savings of time and money on the part of the CFTC, before considering the imposition of a users fee. A users fee could result in a loss of industry support at this critical time.

I sincerely hope that by the time the reauthorization process is completed that the regulatory structure will be clear so that steps can be taken, as quickly as possible, to provide the quality of regulation that this industry must have if it is to continue to grow. Firms such as E. F. Hutton can easily live under a strong tough regulator. Actually, we benefit not only because it is more efficient and less costly to operate under one set of rules and regulations where you know clearly what your duties and responsibilities are, but we also would benefit from a better industry image. This can only come about by better regulation of those who have flagrantly violated the canons of ethics in their dealings with the public, and given the industry a black eye in the eyes of the world.

In regard to the specific proposals of the CFTC, I would like to make several comments.

The CFTC proposal to make a controlled person responsible for a violation committed by a person under his control appears to be much too broad in scope. Some modification should be made in this to bring it more in line with existing requirements in the securities industry. Attorneys for the industry have indicated that in their option this CFTC proposal could make a controlling person liable even if he exercises due diligence and acts in good faith. When one looks at the development of large financial service corporations such as have been put together in recent years, it must be clear that the CFTC proposal should be modified.

Second, the CFTC has proposed that persons who are agents of FCM's be treated as associated persons, whereby FCM's would have responsibility for their acts. In many instances FCM's have little or no control over the acts of employees of agents, and I am in agreement with the industry proposal that a separate registration category of "introducing broker" be established, where such introducing broker would be responsible for supervising his employees.

Third, the CFTC should certainly retain its exclusive jurisdiction over activities in the United States of foreign futures trading. However, the CFTC proposes that it be given unlimited rulemaking authority in this area. I believe the authority should be limited in scope to that necessary to effectuate the purpose of the act.

Thank you. I will be happy to answer any questions you may have.

Senator LUGAR. Thank you, Mr. Johnston, and I appreciate your testimony.

Mr. Heinold.

STATEMENT OF HAROLD J. HEINOLD, CHAIRMAN OF THE BOARD, HEINOLD COMMODITIES, INC., KOUTS, IND.

Mr. HEINOLD. Thank you, Mr. Chairman.[1]

My name is Harold J. Heinold, of Kouts, Ind. I am chairman of Heinold Commodities and Heinold Hog Markets, which are independent subsidiaries of DEKALB AgResearch. With me is Lawrence Hunt of the Chicago law firm of Sidley & Austin, our counsel.

Heinold Commodities was started by me in 1967 and is now one of the largest commodity futures brokers in the country. It has net capital of over $90 million and has more than 100 offices throughout the Nation. Heinold Hog Markets, which I began in 1950, has over 100 hog and cattle markets in 9 States, mostly in the Midwest. Its business is to market hogs and cattle for farmers. Farmers often do not want to get involved in futures contracts and margin calls, so we provide farmers with price protection by contracting to buy their livestock at a fixed price direct from the farm in net dollars to them. We, in turn, protect ourselves by hedging on the futures market.

Today I would like to highlight three areas for the committee: Agricultural options, speculative limits, SEC jurisdiction. Let's start with agricultural options.

I feel very strongly that the current ban on agricultural options should be lifted. With the established commodity exchanges today to control and regulate options, with the CFTC to oversee the exchanges, I see no reason to continue this ban.

Futures markets have given the farmer price protection on his livestock and grain. However, because of past steep market movements requiring large margin calls, many farmers, whether we like it or not, distrust the futures today. Bankers hesitate to loan the farmer if he is not protected with the futures. But bankers are also afraid of drastic market movements that would lead to huge margin calls. So, as a result, farmers often cannot get loans to finance their hedging.

---

[1] See p. 601 for the prepared statement of Mr. Heinold with accompanying appendix.

There is another problem farmers have with the futures markets. A farmer who hedges on the futures market can avoid a net loss of income for his livestock and crops, but he has to give up the chance of some benefit of higher prices. And this is one of the problems we've got.

Agricultural options would give a farmer a better way to protect himself. With the options, a farmer could insure himself against the major drop—I say a major drop in farm prices—and at the same time could benefit from a major price increase.

Options would be like an insurance policy, and the premium paid for an option would be like an insurance premium. If the markets were to move in the farmer's favor, the option would not need to be exercised. Simply let it expire. By the same comparison, if you insure your car and you do or do not have a wreck that year, your insurance expires that year and you renew it next year. If you have a wreck, you collect. The same way for the farmer. If the market moves against that farmer he would exercise his option and collect his option price.

Let's try an example. First, the use of futures contacts. If a farmer has hogs that will be ready to market in December, he can sell a December futures today and lock in his sale price—say 50 cents a pound. And it doesn't make any difference which way the market goes, he will get 50 cents a pound.

What is it going to give him today? A little profit, probably no loss, vary on the position. Now, let's say we've got options, if the options selling at 50 cents per pound in December are available, the farmer could buy this option at a premium—I will give you an example: At 3 cents per pound—if the market should go up to 60 cents, he would not exercise his option. He would benefit from the higher market price, because what he would do, is just would not exercise and sell at the cash market. Now, if the market went down and went down below, he would exercise to get his 50 cents. Realize, of course, he had the 3 cents premium to pay, so he would net 47 cents a pound. In a way the option would be like an insurance policy with a deductible feature.

See, a farmer today can afford a small loss. It's the big loss he cannot stand and he needs a chance to get a profit back when the futures are never able to protect him.

All right, options could also be used to insure against higher feed costs. Let's take the example of a farmer who needs to buy corn for his livestock, he would look at the December options today, and he could buy an option to purchase corn at a set price today of around $2.95 a bushel. All right, let's say he has to pay 15 cents premium to buy that corn. Now, if the market goes down, OK, he takes whatever the market price, he buys his corn for his livestock at the lower farm price, plus the 15 cents premium. He can stand that.

Now, let's say we've got an instance like in 1980 with the dry spell. Corn goes up to $4. It goes up to $4, he's at $2.95 plus his 15 cents, or $3.10. He can still live. He can still feed his livestock, he can get by on that price. What it does is limit his liability.

Now, we all buy insurance to protect ourselves against disasters of one sort or another. The farmer should also be able to do this and the agricultural options would let him do it. By giving this price protection to the farmer, the option would also reduce the need for governmental price supports, such as we have now in dairy subsidies and all that, and this would avoid having Government support the hog and cattleman.

We understand that the CFTC does not oppose the lifting of the ban on the options if there is enough interest in the agricultural community. We heard this morning, and we're glad to hear the Department of Agriculture testify for it. We believe interest does exist and that options would give the farmers a way to protect themselves and insure themselves, something they don't have today.

To save time and just to highlight a little on the speculative limits issue, I'd like to say this, that one of the things that we're very concerned about the speculative limits is this. That you must have a lot more dollars from the speculator's side to take care of the hedger's side to keep a liquid market. It's a must today.

Now, we have to recognize with that that times change as times go. You know good and well that a long time ago when there was only a 2 million bushel limit on grains and we raised it to 3 and we have never raised—for instance on wheat—what the limits are since that time. It's no different than when I started farming. When I started farming in our little town, the limit on the bank was $3,000 that you could borrow. Today if we hadn't changed that, you couldn't even loan to the guy to buy a car, let alone his equipment and machinery and everything. You just have to go with times.

The other issue that I'd like to highlight a little is investor pools. For investor pools we need bigger limits. Why do I say we need those? It is because we've got to have more speculators if we're going to do the hedging down the road.

All right, now, we've got a lot of little investors willing to speculate. But they need professional management, they need limit risk, they just can't go out there, they get too emotional trading, so we need those limits so that we can get those professional people managing a group who deal with limited liability for the small investor.

Another thought is that we've got to keep in mind we always are subject to change on this thing, and right now when we're going on 1930 levels we are to far back.

On the SEC jurisdiction. A few highlights. I think the real key thing is—what is it for? And there are two subjects, one is risk shifting and one is capital formation. There are two different fields today. You've got the CFTC that should be in there in charge of risk shifting, like we need in agriculture. When it comes to capital formation, fine, the SEC is fine. That's their field, that is right. We're selfish, I realize, but we've got to look at agriculture from our position. And agriculture needs the risk shifting and for that we need somebody like the CFTC who was started up by the Department of Agriculture, who sees our interest and it's no more different than asking some baseball umpire to go out and referee a football game. Let's stick to each field where we are. And I feel this is very important to us and we know down the road that you've got some laws coming up that are being tested by the courts and we'd like to see a stall on that issue. Let the courts see how they come out on the thing.

I want to say thanks for your time and I would appreciate any questions.

Senator LUGAR. Thank you very much, Mr. Heinold.

Let me ask first of all about the experience of both the Merrill Lynch and E. F. Hutton in commodity pools. Do you both have pools? Do you offer these to your customers?

Mr. CONHEENEY. Merrill Lynch has been very late in the game, Mr. Chairman. We have one pool which we started last year and are in the process of working to put together two or three more pools.

We do not have—I believe we have two small pools that are in existence. We have not gone this road as much as we have where we have introduced clients who want professional management to outside money managers where we have reviewed what they do and we have approved their approach in such markets.

Senator LUGAR. What would be the effect of shared State and Federal jurisdiction over your commodity pools?

Mr. JOHNSTON. I would think that it would muddy the waters. I do not believe that there is enough expertise in trading in the futures markets in a speculative way in this country to find enough people who could possibly do a reasonable job of regulating the pools. The CFTC at the present time would be the best. If there was an NFA, that would be by head and shoulders above everybody else in this as far as their capabilities.

I think that regulation in this area has to be done by people who know what they are doing.

Senator LUGAR. Let me ask both of you gentlemen. What is the average broker's fee that your firms charge customers to open and close futures positions?

Mr. CONHEENEY. I don't know the answer. We're in the—of course, there is always an average. It runs a wide gammit, depending on the size and volume of business and the like. I would think it's around $60 in round term, in and around that level, $60 to $70.

Senator LUGAR. Can you give some specific examples of charges for different contracts so, for the benefit of the record, we have an idea what that average might be composed of?

Mr. CONHEENEY. Well, say it's a foreign contract, for instance, I think—and I really don't know the answer. I would have to look back—go back home and look, but I would think it would be around the $70 level. We are all different, we all treat each customer in accordance with his own involvement with us, but I think it would be around that area.

Mr. JOHNSTON. I would say somewhere around $60 to $70 overall. But large commercial firms doing business with a brokerage firm or very large speculators would qualify for substantially reduced commissions, particularly if we do not provide other services other than just executing orders on the floor. That could change it substantially, depending upon the mix of business of the individual brokerage firm. But the public in general would be charged around $60 or $70 per contract, regardless of the commodity.

Senator LUGAR. Do futures exchanges charge either of your firms, currently, a transactions fee? For example, the Chicago Board of Trade, does it have a transaction fee paid by your firms?

Mr. CONHEENEY. There is a clearing fee I think all exchanges charge.

Mr. JOHNSTON. I believe all exchanges charge a clearing fee and in some cases there is a fee which is passed through and charged to customers.

Senator LUGAR. How much is the fee?

Mr. JOHNSTON. It varies from exchange to exchange, 50 cents, a dollar, something like that.

Senator LUGAR. Each exchange has a different fee, clearing fee?

Mr. JOHNSTON. This is where the funds come from to regulate the industry.

Senator LUGAR. Do you pass on that fee to customers or what is the incidence of that transactions fee?

Mr. JOHNSTON. On some exchanges it is passed through directly to customers on the closeout statements, and in other cases it is a fee which is charged just to the brokerage firm, in which case it is absorbed by the brokerage firm.

Senator LUGAR. Have either of you given any thought in the event a user fee or transaction tax, or whatever we're discussing here generally, philosophically, is adopted, would you pass that on to your customers?

Mr. CONHEENEY. We would always attempt to do that, Mr. Chairman, but in this era of negotiated commissions and the heavy competition that is involved in this matter, it is kind of difficult to tell a customer that you're going to charge him a fee to make sure the broker is covered.

Mr. JOHNSTON. There is no question about it. If the exchanges get most of their revenues from the commission houses, who, in turn, one way or another, will charge customers.

Senator LUGAR. Mr. Heinold, what is the average brokerage fee that your firm charges a customer to open and close a futures position?

Mr. HEINOLD. The figure they gave, $70, is real close, but keep in mind you will have variations. For instance if somebody puts up T-bills so you get no interest revenue, that is a factor, and vice versa, if it does, it has a factor. There are adjustments. But it will average awfully close to that figure.

Senator LUGAR. From your experience, and you have pointed out the substantial size of your firm and its growth, what would be the total cost of this proposed user fee to your firm?

Mr. HEINOLD. We estimate it would be somewhere between $500,000 and $800,000. But let me say this, as far as the user fee it is going to be passed on in our commission fee. It's all part of the cost of operation. If it's going to be in there, if our light bill goes up, Mr. Chairman, it has got to come out of the kitty and there is no use saying it is any other way. If we got a user fee put it in there, it's going to be passed to our expenses and it has got to be added to our commissions.

Senator LUGAR. So, it would be ultimately passed on to the customer? The problem as it has been stated by your associates on the panel, is that there would be some resistance and some difficulty, depending on competitive circumstances.

Mr. HEINOLD. You've got the bottom line. You don't want to go out of business.

Mr. JOHNSTON. Maybe within the past 2 years that wasn't as important as it is today. But in all agricultural commodities the volume is dropping substantially, the open interest is dropping substantially, as prices get closer to cost of production levels, there's no reason for the price protection as when prices are very high. And as competition is getting tougher and tougher for business it is getting harder to make money.

Senator LUGAR. Well, we appreciate very much your testimony. I will not be able to cover any questions in all of the other areas, but I have read your statements; they are perfectly clear on how you stand, and this will be of assistance to us as we try to measure the views of all the participants in the markets.

Thank you very much for coming this morning.

The Chair would like to call now the final panel of this hearing, Michael Unger, director of the Massachusetts Securities Division, testifying on behalf of the North American Securities Administrators Association, Inc.. He will be accompanied by Orestes Mihaly, assistant attorney general in charge, New York Bureau of Investor Protection and Securities and K. Houston Matney, Maryland Securities Commission.

Welcome. We appreciate your patience in waiting through the extended but very intersting hearing this morning.

As the Chair requested of previous witnesses, please try to speak for 5 minutes and then respond to questions, if you will, so that we may proceed toward an orderly end of our hearing.[1]

STATEMENT OF MICHAEL UNGER, DIRECTOR OF MASSACHUSETTS SECURITIES DIVISION, ON BEHALF OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.; ACCOMPANIED BY ORESTES MIHALY, ASSISTANT ATTORNEY GENERAL IN CHARGE, NEW YORK BUREAU OF INVESTOR PROTECTION AND SECURITIES, AND K. HOUSTON MATNEY, MARYLAND SECURITIES COMMISSIONER

Mr. UNGER. Thank you, Senator.

My name is Michael Unger. I'm the director of Massachusetts Securities Division and a member of the board of directors of the North American Securities Administrators Association. To my right is Orestes Mihaly, chief of the securities bureau of the attorney general's office in New York, and to my left is Houston Matney, the securities commissioner for the State of Maryland.

Mr. Chairman, our presentation is somewhat unique. During the course of the hearings your committee has held you have heard testimony from a variety of sources, primarily from industry and the legal community and some Federal agencies. We represent the States and our involvement in the area is directed toward consumer protection and investor protection, and I think our presentation is rather unique in that regard. What you will be hearing from us is our desire and motivation to protect the investors who are involved in the commodities area.

Part of the problem that we see is the inability of the CFTC to combat commodities fraud through lack of resources and, in part, legislative machinery. That has created a fair number of problems for States since we have by and large in the Commodities Exchange Act, been preempted from our basic State police power to prosecute people involved in commodities fraud.

---

[1] See p. 611 for the joint prepared statement of Mr. Unger, Mr. Mihaly, and Mr. Matney.

We have also proposed legislation and I will go over that during the course of my testimony. It is acknowledged that the CFTC is responsible for regulating commodities and futures markets and it has taken that job seriously and by and large it has done that job fairly well. However, what it has not done very well is the policing of the sales end of those markets. The people who sell to the investors of this country and there has been a great deal of fraud in that area.

The fraud has arisen largely as a result of increased public awareness of the commodities markets as investment vehicles. This has been a natural result of the inflation that has been visited upon our economy and the desire of the public and public investors to find other vehicles to protect their income and their savings from the ravages of inflation. Many of these people who are looking in this area are unsophisticated investors. They are not the farmers you have heard about who are familiar with the workings of the markets, they are not the users of copper and tin and other metals, who know how to hedge and understand those markets. But they are people who are called cold and told that they stand to make great sums of money quickly if they are lucky. But they don't necessarily understand what it is they are getting into. And as a result they have been preyed upon by many unscrupulous people in the field, many of whom do not trade in exchange instuments but offer exchange instruments.

Currently, the methods employed by the CFTC to combat these frauds have been largely ineffective. In fiscal year 1981 they brought 19 injunctive actions under their statute, 12 of those 19 cases were brought against firms that had already gone out of business. The problem is that injunctive relief simply does not meet the needs in policing this area. Injunctions stop conduct that has already occurred in many instances for many months. The same people who may be stopped through injunctive relief will simply go on to another State or another market and set up another corporation under a new name and continue their acts in another fashion.

Provisions under the CEA are just too little and too late. That is why we are asking Congress to very seriously consider returning the basic police power that the States have to States securities administrators and attorneys generals.

The years since 1974, by and large, have visited upon this country a new scandal every year. We all recall the Lloyd Carr commodities scandals and from there these same people moved into gold and silver contracts and they then moved into crude oil, coal, strategic metals, and the latest area where we have seen problems is in commodity pools run, by and large, by unscrupulous people, who unfortunately, have been registered by the CFTC in many instances.

These problems are not new. In 1978 NASAA conducted hearings in the wake of the Lloyd Carr scandal and the results of those hearings produced a task force report.

We are here again 4 years later with the CFTC reauthorization and the problems have not diminished. In fact, they have increased a great deal.

We are in an age under the present administration where the term "New Federalism" is being utilized a great deal. We think the suggestions of NASAA with respect to the New Federalism is very appropriate. We're asking Congress to consider in amending the CEA to give back basic police powers to the States, to allow the States to utilize their prosecutorial abilities and apply their general State statues, as well as securities statutes to combat fraud. This will not cost the Federal Government any additional money. It will simply expand the number of people who are able to police the sales end of the commodities industry to prevent fraud.

We are willing to do it—our legislatures are not necessarily going to give us any more money to do it, Senator, but we want to do it, we're motivated to do it and we're not going to build empires by doing that in our individual States. We simply want to be able to protect our citizens. We are the ones who are aware of the problems. They call us when they have problems. They call the CFTC as well, but they call State securities administrators and attorneys general when they have problems. All we can do now is forward those complaints down to Washington, and in more cases than not it is too late. The cases often just disappear and people lose money. We're not talking about sophisticated investors, again.

There's a possibility that the approach of a self-regulatory organization, be it the National Futures Association, may provide some relief here. The States, however, do not believe this is the case. For one reason, the off-exchange traders, the conmen, the thieves, and the cheats will not register with the NFA, they don't intend to and the stuff they sell won't have anything to do with the NFA.

Second, from all of the reading we've done and statements we have heard during these hearings and over the past years, the industry, by and large, has been opposed to any progressive types of rules or regulations or legislation which would provide fundamental elements of investor protection. Those protections are found throughout the securities industry, the SEC rules, State laws, and regulations and the NASD.

Commodities trading as it affects the average unsophisticated investor, is not very different than securities trading. Yet, the industry has fought tooth and nail against some very reasonable proposals, such as suitability standards, making sure that the customer is able to afford the investment and understands the investment.

Presently the States have some limited authority to enforce Federal law in Federal court under section 6d, and there have been arguments that that is sufficient authority. The States believe that is not the case. It's a cumbersome process. The agency in the first instance, securities administrators, who know and have the expertise to deal with these problems, often must go to their attorneys general to bring the cases. It takes a lot of time and we just cannot respond very quickly.

Similarly, the tendency of State legislatures is not to fund agencies to enforce Federal laws.

Private rights of action are another possible remedy that may be utilized in the area of investor protection. Again, I would say here that largely it is a protection that is useful for a sophisticated investor. The people who are being ripped off by the cheats and thieves are not going to find them around to prosecute a civil claim for fraud. The private right of action is something that we endorse as providing the investor with an additional remedy, but largely that goes to the legitimate areas of the futures industry and it's not going to relieve, or do much to police against, fraud.

In our proposed amendments, Senator, we asking for the following.

One is to further define the jurisdiction of the CFTC, in that there would be exclusive jurisdiction only in areas where there is clear national interest. We don't believe prosecuting criminals is something that should be reserved for the Federal Government, but that the States have an important role to play there.

We're suggesting a registration mechanism. There have been many instances in the States where administrators have noted people who have been filing or about to file with the CFTC. Those people have been approved and they have gone on to commit nefarious deeds and cheat people out of millions of dollars.

The States would like to know when a person registers with the CFTC if they are going to do business in that State. We will then know who is doing business there. We can keep an eye out on them and if complaints come in, they will know that we're watching them.

We would, in turn, petition the agency, if we find instances of wrongdoing, to take appropriate disciplinary proceedings against the person's registration.

We would like to see jurisdiction expanded under 6d to allow the States to prosecute administratively and in court under general statutes, general criminal statutes, general fraud statues, and securities statutes of the States. This is something what will go a long way in deterring the activity that we're talking about this morning. We will put people in jail when we can and we think we will be able to do it a lot faster than the record has indicated the CFTC's ability has been up to date.

The legislation proposes sharing of information with the States and we heartily endorse that. That has been a very major problem that we have had. We do not get information from the CFTC presently in cases where we wish to undertake investigations and we support that effort.

We would also recommend a provision that mandates CFTC cooperation with the States, particularly in the area of sharing information.

The CFTC's proposed legislation proposes concurrent jurisdiction with the States in the area of off-exchange investments, these are the things we are talking about. We support that and we also support the proposal to let the States be able to prosecute individuals who should be but have not registered with the CFTC. That will also be very helpful and we endorse that.

Last, we would suggest that the States be given concurrent jurisdiction over leverage contracts. Leverage contracts are not the instruments generally regulated by the Commodities Futures Trading Commission. They were a special exception carved out for no particular reason as far as we can see. They fit within the definition of securities and the marketing of these leverage contracts as has been seen in the States, are subject to abuse and have been abused and we believe jurisdiction should be returned there.

That's a summary of our remarks, Senator. We have submitted our prepared statement and we would like that made a part of the record. We have also submitted a variety of documents which reflect what we call the horror stories in this area. It tells about investors.

Our membership has also testified over a period of 2 days before Senator Roth's committee and we would respectfully refer this committee to the record that has been developed by Senator Roth to give you a very good idea of the problems we face at the State level.

Senator LUGAR. Thank you very much, Mr. Unger. I would state for the record that indeed the hearings that Senator Roth conducted are very important, and I personally visited with him and hope that we can take advantage of the testimony that you and others have presented to him and the good work of his committee and staff, so that those thoughts might be incorporated in this reauthorization legislation.

Let me ask of you, first of all, how many States are members of your association?

Mr. UNGER. Presently, there are 49 States, that includes the provinces of Canada and the nation of Mexico.

Senator LUGAR. How have the members been consulted with regard to your testimony today? Do they subscribe to this testimony or is there any common view among them about it?

Mr. UNGER. I can unequivocally represent to you, Senator, that it represents the common view. Our presentation here and before other congressional panels is a result of a committee that has prepared and spent many months on it. The problem has existed for a long time. Unfortunately State administrators in the past, several years ago, were in rather intense battles with the agency, the CFTC, when that agency, in fact, intervened on the side of some defendant, saying we had no jurisdiction to bring any State actions.

We think we are over that hump and the agency is being a bit more progressive as far as that is concerned. But the view I'm representing to you, I can state is a shared view.

Senator LUGAR. Your legislative proposals, that is the specific amendments that you have drafted and made a part of your testimony, are endorsed by the 49 member States?

Mr. UNGER. Well, we have not formally presented it to our membership, but it has been distributed. Additionally, we contacted our membership through the mail advising them to advise their respective congressional delegations of the needs of the States with regard to this legislation.

Senator LUGAR. Would they subscribe to these amendments? You have indicated that you have informed the States of the hearings, but what I'm driving at is did they take a look at this legislative language, some of which may be considered seriously very shortly? To what extent could the committee believe that the other States, other than the three that are here today, have been a part of that drafting or have approved the amendments?

Mr. UNGER. I'm not a gambler, Senator, and I wouldn't venture to play the commodities market, but on this issue I think if the NASAA's membership took a vote today as to the legislative package, there would not be a dissenting vote.

Senator **Lugar**. I see.

Now, let me ask each one of you how many criminal prosecutions for securities or commodities fraud have you brought in the last year, or taking a more general view to get a better picture, say within the last 5 years?

Mr. **Mihaly**. Well, Senator, let me answer that. My name is Orestes Mihaly and I'm from New York.

New York seems to be the hotbed for all these boilerrooms that people talk about when they talk about commodity frauds. I guess New York is second to Florida, or Florida is second to New York, as far as the number of boilerrooms, and we have been seriously hampered by the preemption question that exists with respect to the CFTC Act. We have tried to go criminally as much as possible.

The attorney general's office up in New York happens to be unique among the State securities administrators because it has both civil and criminal jurisdiction. Therefore, we can move directly to criminal courts before grand juries and make summary arrests or execute search warrants as much as the local district attorney can.

We have a staff of attorneys and investigators that handle criminal matters directly, but within the last 6 months, Senator, I am pleased to announce that we have shifted our emphasis from the civil injunctive route to the criminal route and we have arrested in excess of 50 individuals for boilerroom activities in New York City. Hopefully, this will become a deterrent to boilerrooms.

We are also engaged in strengthening our criminal laws, both procedurally and with respect to penalties to make it easier for us to prosecute criminally in the State of New York.

So, to answer your question, our office has been responsible for 50 arrests within the last 6 months. And over the years we have taken criminal action where necessary. We have experiences, you know, in the civil cases, where a civil injunction means nothing to these operators who travel from one firm to another, so we have emphasized the criminal aspect.

Mr. **Unger**. Unfortunatly, Massachusetts ranks pretty close to Florida and New York in terms of boilerrooms, although it has quited down recently.

The State has not prosecuted criminally any of these people. Part of it is, I think, a reluctance to undertake possible area where there may be some questions of jurisdiction. However, the U.S. attorney's office in Boston, in Massachusetts, has been very active and there have been prosecutions and convictions. Unfortunately, the effectiveness of that rememdy through the Federal prosecution is really—is based upon the whim of that particular U.S. attorney and how that person prioritizes his prosecutorial leverage.

In Boston there have been more problems and we have been very fortunate to have a good working relationship with that office, as well as the FBI, in developing these cases. But it's a hit or miss kind of thing and restoring this jurisdiction to the States would remove a lot of that chance that you would have that is committed to securities administrators who would argue very strongly with district attorneys and attorneys general to prosecute these cases were committed to do that.

Senator **Lugar**. Mr. Matney.

Mr. **Matney**. Well, Mr. Chairman, if I could respond not directly to your question, but summarize, our experience in Maryland over the last 10 years. In 1973, prior to the congressional action that resulted, if you will, in the problem that we're testifying about today, my office which is part of the Maryland attorney general's office, witnessed the first major nationwide boilerroom being operated from the State of Maryland involving the sale of commodity options.

Within, about 2 weeks from the time that the matter was first brought to our attention, our office was successful in obtaining an injunction under the State securities laws, having a receiver appointed on an ex parte basis for the assets of the boilerroom and in recovering over a period of months thereafter, approximately 50 cents on every dollar invested by investors around the country.

In addition and subsequent to that, as a result of State prosecution, all of the principals of that firm were convicted and ultimately sent to jail. Over the intervening years, our experiences were largely with Lloyd Carr type activities operating from outside the State of Maryland.

The next major activity we had with a Maryland based boilerroom was in 1980. We commenced our investigation and discovered that the CFTC was also investigating the same organization. As requested by the CFTC, we filed a joint action, a civil action, in the Federal District Court. It took a little over 1 year from the time I requested the investigation commenced until that matter was resolved. It was resolved then by consent injunction, a receiver was appointed and even though evidence collected in the course of that investigation revealed that millions of dollars had been taken in by this company, the receiver walked in to find that $7,000 in assets remaining. Efforts by both the CFTC and the Maryland attorney general's office to encourage criminal prosecution by Federal agencies in this area to date have not met with any success.

Our most recent occasion to deal with one of the boilerrooms, again, based in Maryland, involving the sale of so-called coal futures contracts, occurred about 5 months ago. In that instance we notified the CFTC that the activity was going on and that we did not feel the time delays that were attendant to a joint action were appropriate in view of the harm that had been occasioned, and that we were proceeding under the State securities laws, notwithstanding the fact that there may be some question as to the validity of that action.

In essence, what I'm saying to you, is that we ran a bluff. That bluff was successful and within a period of less than 2 months we were able to shut down—strictly through State administrative proceedings—another major multimillion dollar nationwide boilerroom.

To sum up, we do not feel comfortable in either obtaining permission from the Governor to prosecute or persuading local States attorneys that they have clear criminal jursidiction under State law to pursue these kinds of frauds in view of the question as to the preemption of the States. But we certainly feel strongly that if there was again a restoration of authority to the States to proceed under, not only the general laws, but specifically the securities laws, that we would have the necessary police powers to move quickly against these frauds.

I can't emphasize enough that in our experience, not only with frauds in this area, but throughout the area of investments, speed is absolutely essential and States can act more quickly than the Federal Government ever can in circumstances of this type.

Senator LUGAR. Now, Chairman Johnson of the CFTC has testified of his interest in moving toward much better Federal and State relationships. Indeed, some of the testimony that you have presented today, I gather he might subscribe to, although he would have to speak for himself. I would be curious as to what conversations you have had with him or what degree of cooperation you have had in approaching some decisions in this subcommittee?

Mr. UNGER. Well, we endorse some of the progressive provisions in the bill that has been prepared by the CFTC. I have to candidly tell you, Senator, that there has been almost no cooperation between the States and the CFTC in preparing legislative proposals. Mr. Mihaly and myself and two other securities commissioners are on an advisory panel for State jursidiction and responsibilties and we met several weeks ago here with the CFTC and their agency members and one outside member, Mr. Nathan.

At that meeting, we first saw the legislative package and were asked during the course of that meeting as to our thoughts. It was prepared without any input from the States. Prior to that meeting we had attended an audience with Chairman Johnson. We were prepared and anxious to discuss some of these issues, but after 10 minutes he stood up and thanked us for coming.

I am being candid. There has not been a lot of cooperation. The Chairman has made efforts to reach out to the States but he has done that through the attorneys general and not though the securities administrators. Fortunately, the two men flanking me today, their securities divisions are within the attorney general's office and that's not the case with the majority of security administrators. Most of us are in corporation departments or secretarys of state.

So, there has not been a great deal of input. The Director of Enforcement has been very helpful in many cases where we have had joint concerns, and, of course, in preparing this legislation. We have been left at the doorsteps, so to speak and that is why we're urging you here this morning to acknowledge some of the concerns that we have.

Senator LUGAR. Well, the subcommittee will not leave you at the doorstep nor rise after 10 minutes. I will apologize for the brevity of our total examination, given the number of points of view.

Let me ask, could you discuss—any of the three of you, or all three of you—your proposals concerning leverage transactions? And, in particular, why do you believe the States should have authority in this area and the type of registration and regulation that you would envision for the leverage dealers?

Mr. UNGER. Well, leverage instruments are rather unique. They don't fit within the general framework of the Commodities Exchange Act. There are four firms, I believe, who trade in leverage instruments and they were given this exclusive area. I don't know why, historically, I have my suspicions as to why, perhaps they were rather influential and were large and were able to persuade people that what they wanted to do was unique. I don't see any reason to distinguish leverage contracts than ordinary securities.

The marketing of the leverage contracts, if the Senator would review the newspapers, is very, very impressive. People are enticed into some of these programs who have no business being there, particularly in gold and silver which were very hot several years ago, and there rising prices were reported on the front page of all our major newspapers. That was a very ripe opportunity. I would imagine it has slowed down now that the prices of those metals have diminished. But there is no logical reason why they should be given special consideration and we can also look at the competitiveness of that situation. Essentially, they have a nice little niche carved out for themselves and there is a lack of competition. Well, that is not a specific State concern. Ours is one of marketing and the type of complaints we get in the marketing of those products.

Senator **Lugar**. Yes, Mr. Mihaly.

Mr. **Mihaly**. I don't have any specific answer to that question, Mr. Chairman, but in the hope that we won't be preempted here, I would like to make one final point as far as I'm concerned.

I think the bottom line that the State administrators are talking about is that we are able to prosecute fraud wherever it occurs. The amount of fraud that exists in the commodities area is in the hundreds of millions of dollars. Any statute, Federal or State, that stands in the way of prosecuting these criminals should be abolished and it should be done immediately. We are talking on behalf of the investors of the United States.

We have heard a lot of testimony this morning about the farmers and certainly just because I come from New York State doesn't mean I have no concern for the farmers of the United States, particularly because New York is a great farming State also. But I had occasion, a very unique and ironic situation, I had occasion, to talk to a farmer from Oklahoma who told me, contrary to what Mr. Unger said, that he was familiar with hedging. But he had succumbed to the sales pitch of a New York boilerroom operator. He was trying to cover his inflation factor by investing in gold deferred delivery contracts. Unfortunately this farmer from Oklahoma lost $40,000. The last time I talked to him, about a month ago, he was about to lose his farm.

So, there are two ways of looking at the problem. The problems that the industry and agriculture has and also those of the investors have we all represent. We all want the best for the investing public of the United States.

Mr. **Matney**. Mr. Chairman, if I could just underscore part of what Mr. Mihaly is saying here. The confusion or the suggestion of confusion arising by virtue of multiple jurisdiction here, is to a certain extent perhaps a fictional issue and by that I mean, while we are all talking about commodity transactions or commodity fraud, the overwhelming majority of the so-called commodity or commodity-related frauds that we see at the State level, in fact, doesn't involve commodities at all, because the commodities that are being sold don't exist. We're talking about Ponzi schemes in the conventional sense. There have—as testimony before Senator Roth's committee showed—been several instances where persons who attempted to become legitimate commodity salesmen found that the economic conditions or the market conditions or because they, in fact, themselves were being defrauded, precluded the maintenance of an ongoing legitimate commodities program. As one of the assistant attorney generals of Maryland phrased it, they are running a bookie operation, but they are not going to the track and laying off the bets.

They are simply paying off the fellow who comes in tomorrow with the money from the person who came in today. So, the bottom line is that we're not interested in getting into the mechanics of the organized futures markets themselves, we're talking about con operators that we want to see put away.

Senator **Lugar**. Well, we appreciate very much your coming this morning and illuminating this issue of Federal and State jurisdiction so well. It is an area that will be given attention by this subcommittee and I'm certain by the whole Agriculture Committee as we mark up the legislation.

We appreciate your specific legislative proposals for amendments and will look to you for further consultation as we get into this particular area.

This hearing will be adjourned and the Chair will mention that tomorrow we will have another day of hearings on the CFTC. We welcome all who have taken an interest in this to come back for tomorrow morning's hearing, which will commence again at 9:30.

[Whereupon, at 12:20 p.m., the subcommittee recessed, to reconvene at 9:30 a.m., Thursday, March 11, 1982, in room 324, Russell Senate Office Building.]

COMMODITY FUTURES TRADING COMMISSION REAUTHORIZATION

THURSDAY, MARCH 11, 1982

U.S. SENATE,
SUBCOMMITTEE ON AGRICULTURAL RESEARCH
AND GENERAL LEGISLATION OF THE
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, D.C.

The subcommittee met, pursuant to notice, at 9:40 a.m., in room 324, Russell Senate Office Building, Hon. Richard G. Lugar (chairman of the subcommittee) presiding.

Present: Senator Lugar.

STATEMENT OF HON. RICHARD G. LUGAR, A U.S. SENATOR FROM INDIANA

Senator LUGAR. The subcommittee will come to order.

We continue today our hearings on reauthorization of the Commodity Futures Trading Commission.

Since there will be quite a number of questions in open session, in addition to those that might be raised for written answers if the witnesses are to fully respond, we will use the 5-minute rule, and will ask the clerk to ring the bell after the 5 minutes are over. This rule will not be rigorously enforced, but at the same time we would like witnesses to summarize their testimony so that there is time for dialog in the question and answer period to illuminate the parts that are not clear from the written text.

All of the texts in their entirety will be made a part of the record so that all Senators will have the benefit of the full text and likewise the questions and answers which may follow.

First of all, the Chair would like to call on our first witness, Theodore Thomte, the director of the National Association of Futures Trading Advisors, who is president of his own company in Boston, Mass.

Welcome. Please sit here and proceed with your testimony.

STATEMENT OF THEODORE THOMTE, DIRECTOR, NATIONAL ASSOCIATION OF FUTURES TRADING ADVISORS

Mr. THOMTE. Thank you, Mr. Chairman. My name is Ted Thomte, and I am president of Thomte & Co., Inc., in Boston.[1] Our firm is registered with the Commission both as commodity trading advisers and commodity pool operators. I am also a member of the board of governors of the Commodity Exchange in New York and I am a member of the advisory board of the Columbia University Center for the Study of Futures Markets.

---

[1] See p. 635 for the prepared statement of Mr. Thomte.

This morning I am appearing in my capacity as director of the National Association of Futures Trading Advisors, which is a group of professional trading advisers and commodity pool operators.

NAFTA was organized in August 1980 and at this time has about 120 members and we manage about $700 million of commodity funds in these markets. We have membership from all over the United States and we are, in our view, reasonably representative of the views of commodity trading advisers and commodity pool operators and the persons who are in a day-to-day business way dealing with the management of money in these markets.

Our primary concern is the area of the CFTC's exclusive jurisdiction in connection with the States. Perhaps it would be useful if I, rather than go through my entire testimony, merely summarize as you suggested.

Under the existing Commodity Exchange Act authority, no person may carry on a business as a commodity pool operator, that is a CPO, unless registered as such with the CFTC. The act defines commodity pool operator as one engaged in a business in the nature of an investment trust, syndicate or similar form of enterprise and who solicits funds for the purposes of trading in futures contracts.

The act also provides that the CFTC shall have exclusive jurisdiction with respect to accounts, agreements, and transactions, involving futures contracts and certain other transactions; hence, the activities of commodity pools. That is, the purchase and sale of commodity futures contracts clearly constitute accounts, agreements or transactions which are within the exclusive jurisdiction of the CFTC.

Pursuant to such authority, the CFTC has promulgated comprehensive regulations that include disclosure documents calling for the disclosure of risk, conflicts of interest, fees, expenses, performance data, and any other material information in addition to recordkeeping and periodic reporting requirements meeting specified high standards.

NAFTA cooperated extensively with the CFTC in developing this very extensive scheme of regulation that we feel covers this field very well and serves the public well in providing a great deal of information in a standardized format so that the citizen can make comparisons from one document to another. It is equally clear, however, that interests in pools, typically sold as limited partnerships, are securities either requiring registration under applicable securities laws or exemption therefrom pursuant to private placement or other exempt transactions.

Accordingly, it is the current industry practice to register with the CFTC and the States interests in any public commodity pool offering, thereby subjecting such offering both to securities and commodity requirements at the capital formation stage and to CFTC regulation and oversight in the operation stage.

Moreover, the Central Securities Administrators Council and more recently the North American Securities Administrators Association have promulgated proposed guidelines for commodities pools which in effect duplicate and/or conflict with the CFTC regulatory scheme mandated by Congress. Regretfully, certain States under the guise of merit regulation formally or informally apply such guidelines or other operational criteria to commodity pools in contravention to the CFTC's exclusive jurisdiction.

The CFTC/SEC accord is a jurisdictional agreement which addresses this question and proposes to establish more clearly jurisdictional authority over commodity pools. While retaining the CFTC's regulatory authority over commodity pools, the CFTC/SEC accord, if adopted, would specifically require registration of interests in commodity pools with the SEC unless a Federal securities exemption is properly available.

Accordingly, in connection with the offer and sale of interests in commodity pools, the CFTC/SEC accord would confirm the availability of any right or remedy available to private parties arising under either the Securities Act of 1933 or the Security Exchange Act of 1934 governing transactions and securities or persons engaged in such transactions.

State security blue sky regulation of commodity pools is specifically preempted, including all matters related to the operation of commodity pools.

The National Association of Futures Trading Advisors, who I am representing this morning, supports the CFTC/SEC accord with respect to joint Federal regulatory authority over commodity pools. In essence, the CFTC/SEC accord States that interests in commodity pools are securities requiring registration with the SEC unless exempt. The proposal would preempt blue sky regulation of commodity pools under various State securities statutes.

NAFTA believes the CFTC/SEC accord should be adopted to insure the continuation of uniform national comprehensive regulatory requirements for commodity pools. The structure of 50 additional State regulatory schemes being applied to a business already thoroughly regulated both by the SEC and CFTC looms as redundant in the extreme and contrary to the earlier congressional position.

In short, we support the CFTC position on this matter and support it strongly, but we are concerned about duplicative and very expensive regulatory processes being extended formally and informally by the States.

Senator LUGAR. Thank you very much for summarizing your testimony. Let me ask these questions. I raise two questions first of all on behalf of Senator Huddleston, of Kentucky, a member of this committee who is unable to be here at this particular part of the hearing. He asks, and I would ask in his behalf, is it true that some States will not register a commodity pool even if it has a major underwriter such as Merrill Lynch, Thompson McKinnon Securities, or Shearson-American Express, and the commodity trading adviser and the commodity pool operator have a proven track record?

Mr. THOMTE. Yes, sir, that is the case. Those of us who deal with this industry in a day-to-day way have seen again and again major underwriters seek to get registered in different States and make this alternative investment available. But in Texas, for example, and in South Carolina, I am told—by persons who have sought to get registration through major underwriters in those States—that it simply is not possible.

As a consequence of that, what we find is that citizens in those States cannot have commodity pools available to them and they consequently are not making funds available that are used in these markets and adding liquidity to these markets.

Our concern is that these States, particularly Texas, have been very active in the North American Securities Administrators Association and it is somewhat ironic in our view that the one State that has not in recent years ever even admitted a public pool is so active in this area, essentially keeping people out of this whole sector and reducing the liquidity in the marketplace over time.

Senator LUGAR. Senator Huddleston also asked for the benefit of the record this question: The subcommittee has, I understand, received testimony to the effect that some States are under the impression that they are totally preempted from prosecuting commodity frauds. Would you please comment on that situation?

Mr THOMTE. That is incorrect. It is widely viewed as the case and it simply is not so. NAFTA strongly supports well designed disclosure standards as well as diligent enforcement of antifraud standards by Federal and State authorities. In fact, in its recent comment letter to the CFTC, NAFTA urged the CFTC to take a greater enforcement role in the area and to encourage supplemental enforcement by the States. NAFTA believes that the State enforcement experience provides a valuable supplement to the CFTC antifraud enforcement efforts. In this fashion, we believe the public will be better protected against the frauds that are out there, while at the same time those legitimate operators in the industry will be subjected to only one uniform national scheme of regulation, rather than 50 additional rule books regulating this area on a State-by-State basis.

So the case of it is now: There is jurisdiction in the States, the States can prosecute fraud. We strongly support that. All legitimate business interests in this area strongly support the States' current capacity in that area and in fact we feel that the new CFTC/SEC accord further underlines that currently available jurisdiction.

Senator LUGAR. Just in trying to wrap up this entire State picture, let me raise these questions, some of which you have addressed. What legislative changes, if any, are needed in your judgment to specifically spell out the role of the State securities commissioners, taking into account the role they currently play and the role that they should play in your judgment, as we try to take a look at this whole area of State enforcement? You described in part, of course, what they are currently doing and likewise touched on what they should be doing, but legislatively how should we address this issue?

Mr. THOMTE. I think that probably the best solution lies in that carefully developed and carefully worked out CFTC/SEC accord. The Commission has worked hard to try and address a number of areas and they certainly have in this area. It would permit the States enforcement roles in the fraud area.

The thing that it would preclude though, is the problem that we see as businessmen going into State after State, and some places not being permitted to even offer this kind of investment. Further, it would make clear that the will of the Congress is that the accord be implemented and implemented in the way that the SEC and CFTC have already agreed upon. I think that that probably would serve the States well because it does not preclude their going after the crooks. The legitimate business people in this area are very substantially harmed by commodity scams.

One of the things that perhaps is worth stating: the CFTC/SEC accord and the CFTC's general thrust in reauthorization will take many of the problem areas and put them clearly outside the CFTC's area—problems that have occurred in coal, problems that have occurred in diamonds, areas that are not part of the CFTC's purview.

So I think the short answer, Senator, is that the CFTC/SEC accord does address this and addresses it appropriately.

Senator LUGAR. Does your association have any fitness standards for membership?

Mr. THOMTE. We are in the process now of discussing that, particularly with people at the National Futures Association, and NAFTA is cooperating with NFA in that area. Fitness in this field is a very complicated one. My own firm, for example, employs Ph. D. level people who come from fields other than commodities, and we had one very able person whose background was a Ph. D. in nuclear chemistry. You might wonder why that fits in this industry. The answer is: His field is data analysis and that is our interest, but he has no commodity experience.

Another person I could readily see might be very valuable might have had no formal education but many years in the soybean markets. So saying who is an appropriate person is a difficult problem. Is my Ph. D. who has lots of background in data analysis an appropriate person? I would say yes, but he does not know about commodities. On the other hand, is someone who comes out of the raw industry who has lots of practical experience an appropriate person? I would say yes, too, but it becomes hard to decide on standards and we are trying to address that question and develop some appropriate guidelines in that area.

Senator LUGAR. What steps, if any, has your association taken to remove any dishonest or disreputable pool operator or trading adviser?

Mr. THOMTE. As a private trade organization, our advice from counsel is that we have very little power in that area. In our view, that is an appropriate role for the CFTC. As National Futures Association develops, we are going to work cooperatively with them in this area, but right now we are advised if we ever did anything in that area we probably personally would be exposing ourselves to substantial possibility of action by someone who we may have taken action against. We do not have the capacity to do that at this juncture.

Senator LUGAR. Why does your organization oppose Federal control of margin authority for futures contracts?

Mr. THOMTE. Basically, our view on that is that the margin requirements can and do change rapidly in response to risk in the marketplace. Our view is and our concern is that if they were not handled by the exchanges, it would be difficult to have them adjust to market conditions rapidly and that probably is most appropriately an area that should be under continuing exchange control.

Senator **Lugar**. Would you discuss briefly the relationship between the activities of commodity pool operators and commodity trading advisers?

Mr. **Thomte**. The commodity trading adviser can be viewed as the decisionmaker. My firm is registered as both, but we decide whether we should buy wheat today or sell soybeans today as trading advisers. Those market, buy, and sell decisions made by us as trading advisers.

The pool operator, on the other hand, is the person who frequently acts as a general partner in many commodity pools and is handling the business aspects of putting the programs together, reporting to the partners. It is more a business function; the trading adviser is the buy-and-sell decisionmaker.

Senator **Lugar**. You have touched upon this before, but for the record illuminate again what difficulties would you anticipate if States were given concurrent jurisdiction over commodity pools.

Mr. **Thomte**. One basic difficulty is the attitude of some of the States that they simply do not want to see commodity pools in their jurisdictions, and they are straight-arming people who are among the most reputable in the United States and preventing them from entering their jurisdictions.

The other aspect of that is we are seeing rather arbitrary and capricious application of guidelines by persons who are not really familiar with the industry. One of the purposes, of course, of having a CFTC that develops some substantial expertise in the area was to develop some knowledge so that there could be appropriate regulation.

We are seeing in the guidelines, for example, regulations that came out of the oil and gas industry and regulations that came out of the real estate industry. When you seek to apply them to commodities, they simply are not appropriate. There now is an extensive scheme of Federal regulation in place.

Senator **Lugar**. Thank you very much, Mr. Thomte, for very well-informed and lucid comments and answers. We appreciate your coming this morning.

Mr. **Thomte**. Thank you very much, Senator.

Senator **Lugar**. The Chair would like to call now Clint Burr, a private attorney, to testify.

Welcome, Mr. Burr.

STATEMENT OF CLINTON BURR, GENERAL COUNSEL, ROSENTHAL & CO., CHICAGO, ILL.

Mr. **Burr**. Good morning, Senator. My name is Clinton Burr. I am a private attorney in practice in Chicago, Ill.[1]

I spent approximately 3½ years with the Commodity Futures Trading Commission, working on the reparations program from the end of 1975 until mid-1978. Since then I have been in private practice in Chicago. I am counsel for Rosenthal & Co. In addition, I have several other private individual clients. I have handled at least 100 various matters in the reparations forum in the State courts and the Federal courts.

---

[1] See p. 649 for the prepared statement of Mr. Burr.

What I would like to talk about this morning would be the reparations program which is conducted by the CFTC. I think on the whole it is a very good program because what we have is we have a specialized form of limited jurisdiction. We have a body of administrative law judges who have expertise and understanding in the area of commodities trading.

Now, commodity trading involves many technicalities. For example, I have had the experience of trying to explain equity and paper profits to a jury and on the fourth day the judge had to take over that function because I just could not explain it in simple language.

The advantage to a reparations trial is it takes one-fifth the time of Federal or State court. Because of the way that the reparations forum is structured, it takes approximately one-tenth the cost. There are no pretrial hearings, no pretrial conferences, no attendance. Everything is done by mail or telephone.

Now, regarding possible changes in the CFTC's reparations program, I think that perhaps this committee should be concerned with eliminating the CFTC's dual role in connection with reparations. That is, under sections 14a and 14b of the act, the CFTC has the duty to investigate and make a decision on each complaint prior to initiation of the proceeding.

Now, the CFTC internally back in 1975, before the rules were promulgated, determined that it did not have the staff nor the resources to properly investigate and prepare an investigative report on each complaint prior to initiating a hearing.

Since 1976, the investigative function has been called a screening function. Perhaps the statute should be amended to clarify the fact that the CFTC does not investigate and prepare a report. I have seen actual experiences where complainants appear at the hearing totally unprepared for a trial because they have the misapprehension that the CFTC's enforcement division will be prosecuting the complaint for them.

This should be clarified. It is the CFTC which internally should prepare a brochure to be forwarded to each party to a reparations proceeding and carefully explain that the CFTC merely provides a forum and will not actually prosecute the complaint for them.

Another possible change—and this is one being proposed by the CFTC—is that reparations proceedings be conducted only against registrants, that is, persons who are registered with the CFTC and over whom the CFTC has some authority.

Now, in 1978 the statute was amended to bring in nonregistrants, that is, those persons who have been employed by Lloyd Carr or other nonregistered London options dealers. Now, the practical effect of this has been to flood the reparations forum with numerous complaints involving individuals over whom the CFTC has no control, that is, decisions are rendered against these nonregistrants but they are totally unenforcible.

Now, the CFTC has recommended that this committee adopt a new section 14b which would give the CFTC a blank check to promulgate whatever rules and regulations it wished. This is to cure the delays in the matter and this is not going to be an effective cure.

Thank you, sir.

Senator **Lugar**. Thank you, Mr. Burr. I appreciate your testifying from your very considerable experience and your prepared statement is most helpful in that respect. Let me raise these questions:

One means of improving the performance of the reparations program is to make available a significantly greater amount of resources, as you suggested. Can you comment on Chairman Johnson's statement that as long as the reparations program is applicable to nonregistrants who should have registered with the CFTC, the resource needs of the program are not only great but very uncertain, as hundreds of claims may arise as a boiler operator appears one day out of nowhere.

Now, you touched on this in the final paragraph of your testimony, but would you go into this further? Apparently Chairman Johnson has put his finger on something with which you are in agreement. How would you address this problem?

Mr. **Burr**. Well, if you look at the total budgetary expenditures of the CFTC, you will find that out of a budget of in excess of $17 million, the total expenditures for the reparations program—and the reparations program includes the overwhelming majority of the CFTC's efforts in the consumer protection area—the entire expenditure is under $400,000 on an annual basis.

So at present it would be hard for me to believe that the CFTC is devoting a large proportion of its budget to the actual workings of the reparations process. Now, if Congress were to delete the jurisdiction over nonregistrants, that would certainly reduce the number of claims, and also this is really a proper area for State concern. Many of these nonregistrants are persons who are involved in local sales schemes. It just so happens to touch upon the area of commodities and therefore reparations claims are being brought before the CFTC, the CFTC may have had absolutely no knowledge of the company's existence prior to the reparations claim being filed.

And also a third thing that I would like to point out is that in 1977, as I recall, the number of claims was under 200 a year. Now, in 1981, I understand the number of claims to be approximately 1,500. In 1977, the Commission did not have jurisdiction over nonregistrants. So I believe deleting the jurisdictional provision would greatly reduce the number of claims being filed in the reparations forum.

Senator **Lugar**. In addition to restricting reparations to registrants, the CFTC's proposal to deal with the delays and high costs of the reparations program seeks greater flexibility in the reparations procedures, including rules which establish who is entitled to a hearing on a record before an administrative law judge. Do you believe parties can get a fair and impartial hearing before a hearing examiner as well as an administrative law judge?

Mr. **Burr**. No. I believe that the administrative law judges are bound by the Administrative Procedure Act. They are on a Federal register. They are graded. They have standards that they must comport with. A hearing examiner would be responsible to no one but the internal guidelines of the CFTC, and that probably is the main reason for the present problems with the CFTC's reparations program in that the CFTC has failed to promulgate a set of internal standards and guidelines for persons who are performing functions in the Commission involving this program.

Senator LUGAR. Since any CFTC proposed rules for the reparations program would be subject to comment by members of the public such as yourself as well as the standards of the Administrative Procedure Act, do you believe the Commission would establish fair and equitable procedures?

Mr. BURR. Yes, I do believe that if the Commission were to conduct a rulemaking proceeding and if they were to propose for comment, that the Commission would respond to suggestions from the public. I do believe that is correct.

Senator LUGAR. Mr. Burr, I thank you very much for coming this morning, for your statement, and your forthcoming response to the questions.

Mr. BURR. Thank you very much.

Senator LUGAR. The Chair would indicate that George Rosenthal, chairman, National Affairs Committee, Independent Bakers Association, who was to have been our next witness, has been delayed due to weather problems—the fog, mainly. His plane has not arrived, but he is hopeful of being here later. So we will delay that testimony and call now a panel of witnesses, including Louis E. Carabini, president of Monex International, Newport Beach, Calif.; James J. Groberg, chairman of the board, International Precious Metals Corp.; and David F. Simon, general counsel, First National Monetary Corp., of Southfield, Mich.

Welcome, gentlemen, to this hearing. If I may, I will ask each of you in the order that I called your names to testify with a summary of your written material, of about 5 minutes in time, and then we will engage in questions and answers at that point.

STATEMENT OF LOUIS F. CARABINI, PRESIDENT, MONEX INTERNATIONAL, LTD.

Mr. CARABINI. Thank you very much. Good morning, Mr. Chairman. My name is Louis Carabini, and I am president and chairman of the board of Monex International.[1]

Monex's principal activity is the purchase from and sale to private individuals of precious metals, primarily gold and silver, both on a cash basis and pursuant to contracts commonly known as leverage contracts.

Since its organization in 1967, Monex has engaged in over $7 billion of such commodity transactions, with more than 70,000 customers, has grown into one of the world's largest suppliers of precious metals to private individuals.

The company currently has over 10,000 active customer accounts. The Commodity Futures Trading Commission has come before this subcommittee and asked that it be directed to conduct a 2-year study of the leverage industry. The purposes of that study would be to ascertain what leverage contracts are, to determine whether they are futures contracts—which they clearly are not—and to decide how leverage contracts should be regulated.

---

[1] See p. 659 for the prepared statement of Mr. Carabini.

The proposal is a source of great frustration to the leverage industry. We have twice asked and Congress has twice before directed the Commission to regulate the leverage industry, but the Commission has steadfastly refused to do so. Now the agency seeks to conduct yet another study to address the questions which have already been answered and answered repeatedly.

I have two questions: One, why do we have to go through them again; and, second, why does not the Commission settle down to doing what Congress has asked it to do?

I believe the reasons for the Commission's positions are readily apparent, but before addressing them I would like to take a few moments to answer the questions which the Commission would address in its new study.

First, what is a leverage contract? In short, a leverage contract is a standardized agreement for the purchase from or sale to a member of the general public of a specified commodity in a standard unit and quality for delivery at any time upon payment in full.

The principal characteristics of a leverage contract include: First, standard units, quality and terms and conditions; second, payment and maintenance of margin; third, payment of carrying or leverage charges on the unpaid balance of the purchase price under the contract, which payment may vary and be paid periodically, or be fixed in advance and prepaid for all or a portion of the term of the contract; fourth, close-out by an offsetting transaction or by delivery, after payment in full; and fifth, no right or interest in a specific lot of the underlying commodity until delivery.

The leverage dealer is the principal to every such transaction and functions as a market maker, covering its obligations to its customers by maintaining physical inventories and by engaging in transactions in the cash forward and futures markets.

Leverage contracts are perhaps best understood by reviewing the history of their development, which is in large part a review of the Monex history. Monex was originally founded as a small coin shop in Long Beach, Calif., some 15 years ago. In response to the demands of our customers, the company began to sell bags of silver coins to the public on a cash basis.

Because the maximum amount a customer's investment in a bag of silver coins could decline with the difference between the base value of the coins and the value of the coin silver content, our customers were able to finance their purchases by borrowing the base value of the coins from banks and pledging the coins as security for those loans. As the demand for silver coins grew, such financing arrangements became increasingly popular.

However, most commercial banks and other financing institutions were and still are ill-equipped to take physical possession of a bag of silver coins and for this reason it is sometimes proved difficult for Monex's customers to obtain the financing they desire. As a result, as Monex grew it began to extend credit directly to its customers.

At about the same time Monex also began to repurchase bags of coins from its customers, thereby providing them with a ready two-way marketplace in which they could conveniently sell their precious metals without incurring the inconvenience of finding a retail dealer willing to purchase their coins and without being forced to suffer the substantial discounts imposed by many such retail dealers.

With these innovations in Monex's business, the modern leverage contract was born. With this understanding of the evolution of the modern leverage contract, you can easily see that leverage contracts and futures are distinct and separate instruments. The two instruments differ significantly in, among other things, duration, both in practice, and under their contractual terms, size, delivery terms, nature of the initial payment made with respect to each, the frequency or, in the case of leverage contract, the infrequency which calls for additional moneys are made, the pricing mechanism for each instrument, the commodities offered pursuant to each instrument, and the parties to each instrument and the purpose for which each instrument is used.

Leverage contracts and leverage transactions essentially involve the purchase of commodities at the current, spot or cash market price and the payment of a leverage fee on the unpaid balance of the purchase price. Futures do not. Leverage dealers issue firm price quotations to their customers which are, of course, unavailable with futures, and offer expanded trading hours over those available with futures. There are no locked markets or limit moves in the leverage area as there are with futures.

Delivery under a leverage contract is made promptly upon demand at any time during the life of the contract upon payment in full of the remaining balance due and at virtually any place within the United States, while delivery under a futures contract can only occur in the specified delivery month under the contract and only at a few designated delivery points.

The primary economic justification for the existence of the futures markets is that they can be used as a mechanism for hedging by commercial enterprises. Futures contracts are specifically tailored to encourage this type of hedging activity, and one of the Commission's primary responsibilities is to promote such usage of the futures markets.

In contrast, leverage transactions were not designed to be used by commercial enterprises as hedging vehicles or otherwise. Instead, they were specifically designed to be utilized by individual investors, investors who for the most part wish to hold a portion of their wealth in assets with historical intrinsic value as protection against the effects of inflation and other adverse economic conditions.

This brings me to the third area to be addressed by the proposed Commission study and that is how should leverage contracts be regulated. As long ago as 1976, one of the Commission's advisory committees—one incidentally on which Chairman Johnson himself served—made specific recommendations as to how regulation of the industry should be accomplished.

Next, the Commission staff prepared a detailed study of results for the leverage industry. Finally, frustrated by the Commission's inaction, members of the leverage industry submitted not one but two comprehensive rulemaking proposals to the Commission explaining at great length how the industry should be regulated.

I would suggest that if the Commission wishes to learn how to regulate the leverage industry, it already has all the background it needs.

I believe the actions which have been taken by the Commission are not because of any harm shown to have been caused to the public by leverage transactions but simply to avoid having to expend the effort to adopt and enforce substantive regulations for leverage transactions. In short, for the purposes of its own regulatory convenience, the Commission would destroy a legitimate economic activity in which tens of thousands of American citizens participate each year and deprive the American public of a vehicle through which they can protect themselves against the effects of inflation and other adverse economic conditions.

The Commission's continuing refusal to regulate the leverage industry and its hostile attitude toward the industry have surrounded companies in the industry and their customers with a shroud of doubt and uncertainty. The difficulty in operating a business in such an atmosphere can hardly be overstated. The unjustified moratoriums which the Commission has imposed against the entry of new firms into the leverage business have served to intensify the pall over the industry.

Now the Commission is asking Congress to sanctify those moratoriums by incorporating them into the act. Such a request can only be termed unconscionable.

In making this a little brief I would urge the Congress and this subcommittee to refrain from giving the Commission yet another opportunity to shirk its responsibility and ask that this subcommittee recommend to the Congress that it, one, reject the Commission's legislative recommendations in the leverage area and instead, two, repeal that portion of section 19 of the act which permits the Commission to treat leverage contracts as futures, and three, replace that section with statutory provisions specifically directing the Commission to adopt substantive regulations for the leverage industry at its earliest opportunity.

Thank you very much, Mr. Chairman.

Senator **Lugar**. Thank you very much, Mr. Carabini.

Mr. Groberg.

STATEMENT OF JAMES J. GROBERG, CHAIRMAN OF THE BOARD, INTERNATIONAL PRECIOUS METALS CORP.

Mr. **Groberg**. Mr. Chairman, my name is James J. Groberg. I am chairman of the board of International Precious Metals Corp. and I would like to thank you for the opportunity to present this testimony in connection with S. 2109 and reauthorization of the Commodities Futures Trading Commission.[1]

IPMC is a wholly owned subsidiary of MultiVest, Inc., a publicly held company, with over 600 shareholders, whose subsidiaries are engaged in the real estate and commodities businesses.

IPMC was formed in 1973 and has since then engaged in the sale to the public of precious metals through a transaction known as a leverage contract. Although an oversimplified definition, a leverage contract has been described by a House Appropriations Committee study as a purchase of commodities on the installment plan.

---

[1] See p. 665 for the prepared statement of Mr. Groberg.

Our company is located in Ft. Lauderdale, Fla., and we employ approximately 160 people. We have approximately 3,000 customers and our 1981 gross sales totaled approximately $94.5 million. The net worth of IPMC as of December 31, 1981, was $7.65 million.

We are registered with the CFTC as a commodity trading advisor.

Mr. Chairman, I appear today to express a deep sense of frustration. This is the third time in a span of 8 years that IPMC has addressed Congress seeking nothing more than a settled regulatory atmosphere in which to conduct our business.

In 1974 Congress included within the charter of the new CFTC the regulation of companies engaged in the sale of commodities through leverage contracts. Section 217 prohibited any person from entering into a leverage transaction contrary to any CFTC regulation designed to insure the financial solvency of the transaction or to prevent manipulation or fraud. The conference report clearly directed the new CFTC to regulate these transactions.

In my written statement I have described in considerable detail the erratic and confusing record of the failure of prior Commissions to have regulated our industry. I respectfully direct your careful attention to that record.

In summary, after starting, stopping and finally asking Congress to relieve it of its leverage responsibility in the 1978 reauthorization, the CFTC was once again told by Congress to regulate this business. The 1978 conference report said, "It is the intent of the conferees that the Commission act expeditiously * * * to regulate * * * leverage transactions in gold and silver."

Instead, the CFTC has proposed, subsequently twice postponed and, finally, withdrawn a determination to ban leverage transactions. Naturally, we were pleased with the recent action of Chairman Johnson and the Commission in rescinding that proposed ban, but at the same time the Commission appears only to have asked for yet another 2 years to study whether it should ban leverage transactions anyway. It also asks Congress to ratify and extend its 4-year-old temporary anticompetitive moratorium not only on the entry of new firms into our business but also on product competition among those now in the business.

With the utmost respect for and confidence in Chairman Johnson and the other new Commissioners who inherited this record, I must nevertheless express my frustration and exasperation. The record of failure and inaction may not belong to them personally, but it now belongs to them institutionally. In a few more months another new Commissioner will inherit it, next spring another. Between now and September 30, 1984, three of the five sitting Commissioners will be gone. Will their successors need more time to study our business? After 8 years, nothing could be more clear than that Congress must direct the CFTC in the most absolute and unequivocal terms to regulate this industry rather than continue to pursue virtually every imaginable means to avoid doing so.

For 8 years, our company has not been able to conduct long-range planning essential to the solid growth of any corporation. Our employees and their families have been subjected to a continu-

ously shifting threat that their source of livelihood will be banned by the Federal Government. Because of the moratorium on new commodities, we cannot even compete with each other in commodities which one of us might have been selling in February 1979 that another company was not. IPMC sells copper, Monex and FNMC cannot. They sell platinum, we cannot.

I am certain that you have all seen reports in the press about Senator Roth's investigation, of witnesses who are victims of scams and boilerrooms and of the demands for expanded regulatory authority to stop the crooks. We, too, are harmed by the association and infiltration by these crooks.

Throughout this period of delay and neglect, I believe this industry has clearly demonstrated that its products are useful, and that it is very mindful of its obligations to public customers.

We have scrupulously maintained customer equities and coverage in special accounts held exclusively for the benefit of our customers. Our account executives are thoroughly trained and supervised. They are required to pass the NASD commodities examination, since the CFTC has none, and they are registered with the CFTC as associated persons.

We have strict requirements that our customers understand the risks and are financially suited to invest in precious metals. We do not engage in cold call sales to customers. We have a full-time compliance staff and an internal compliance program equal to any in the commodities or securities industry. Most importantly, we have thousands of customers who believe in and use our products. They agree with many prominent economists and advisers who suggest that some portion of an individual's investment portfolio be maintained in precious metals. Inflation is a serious threat to our individual abilities to hold the value of our assets. Precious metals have historically offered protection against that threat.

Through a leverage transaction they can purchase this protection on margin. Our customers deposit a significant downpayment, at least one-quarter of the value of their purchase, and subsequently pay carrying charges on the unpaid balance of their account. At any time a customer can pay this unpaid balance and take delivery of the commodity. Without guaranteeing to repurchase customer positions, IPMC has nevertheless continuously maintained a market to enable its customers to close out their position without taking deliveries.

And I would like to digress by mentioning that in the silver crisis in 1980, IPMC took a $7 million loss as a result of continuously maintaining a market that many others in peripheral industries did not maintain.

In conclusion, we are asking Congress to instruct the CFTC in unequivocal terms to regulate our industry. Further analysis would be wasteful and redundant and the proposed study should be rejected.

Additionally, since the CFTC has attempted for 4 years to use the authority of section 19(d) to ban all leverage transactions, we urge you to repeal that authority. Comprehensive and uniform regulation is all that we continue to seek. Our industry's records through 8 years of experience in a regulatory vacuum should clearly distinguish our business from those operations over which the States seek additional regulatory power.

Because of the nature of our business, a single source of regulatory authority is critical. By adopting stringent regulations, the CFTC can assure Congress and the States that the participants and new entrants into the leverage business will continue to insure the financial integrity of our industry.

Thank you, sir.

Senator LUGAR. Thank you very much, Mr. Groberg.

Mr. Simon.

Mr. SIMON. Good morning, Mr. Chairman. In the interest of time, I will summarize my statement and ask that the entire statement be entered in the record.[1]

Senator LUGAR. It will be entered.

STATEMENT OF DAVID F. SIMON, GENERAL COUNSEL, FIRST NATIONAL MONETARY CORP.

Mr. SIMON. Mr. Chairman, I am a member of the law firm of Simon, Deitch, Siefman & Tucker, and in that capacity we serve as general counsel for First National Monetary Corp. I am also a member of its board of directors.

First National was formed in 1977 to engage in the sale to the public of certain precious metals on a cash-and-leverage contract basis. First National has its headquarters in Southfield, Mich., and also has four additional branch offices in New York City, Miami, Dallas, and Irvine, Calif. The company employs in excess of 290 persons throughout the country.

We have requested this time to testify before this subcommittee so that we might address a limited number of important aspects of S. 2109 which impact upon the leverage industry.

Since First National's formation in 1977, we have observed, as no doubt members of this subcommittee have also, a marked increase in the public's awareness and acceptance of the role played by commodities trading as an investment tool.

Mr. Chairman, I would like at the outset of my testimony to say and to make clear that even though we propose some suggested changes in S. 2109, we do not in any way wish to imply criticism of Chairman Johnson. While we have not agreed with him on every issue before the CFTC, there are important aspects of the Commission's proposals which we support and we do believe that he is truly an outstanding and knowledgeable Chairman, and we look forward to working with him and his fellow Commissioners during the coming years ahead.

There are, however, a few areas of the proposed legislation involving the regulation of leverage transactions that I would like to address.

Since 1974, several CFTC studies of the leverage industry have been conducted. Input from members of the industry has been sought—and provided by several of the leading companies within the leverage industry—including First National Monetary Corp.

---

[1] See p. 672 for the prepared statement of Mr. Simon.

Draft regulations have been prepared, but never implemented. In short, no comprehensive Federal regulatory scheme exists today.

It is against this backdrop that we offer our specific comments on the CFTC's proposed legislative package. Briefly, we have the following recommendations:

First, the new legislation, in our judgment, should mandate that the Commission adopt forthwith a permanent regulatory scheme for leverage trading. The proposed 2-year study by the Commission would continue for 2 more years the uncertainty and regulatory vacuum in which all forms of leverage trading have existed to date. It would also allow for a finding that certain or all leverage trading may be deemed a futures contract and, consequently, that trading therein should be banned.

The study proposed in section 25 of S. 2109 should be eliminated and Congress should direct the adoption by the Commission of uniform leverage trading regulation. It is essential that the regulatory scheme be administered by the CFTC, which has the requisite commodities expertise, rather than any other Federal agency or the individual States.

Suggestions that the 50 States separately regulate this industry, or any other segment of the recognized commodities industry for that matter, are ill founded in my judgment, and such a result would only create confusion, costly duplication, conflicting standards of regulation, or the complete absence thereof in the event that any States might fail to act in this area. However, proposals that the States participate in the enforcement aspect of Federal commodity laws are sound and we support those proposals.

Second, current section 19(d) of the Commodity Exchange Act should in our judgment be eliminated in its entirety. The proposed CFTC legislative package leaves intact the provisions of section 19(d), which allow the Commission to effectively ban all forms of leverage trading. At best, its language is inconsistent with the legislative history underlying the 1978 amendments to the 1974 act and congressional intent as expressed in various correspondence to the Commission from members of the Senate Committee on Agriculture, Nutrition, and Forestry, and other Members of the Congress.

In making our recommendations, Mr. Chairman, I am mindful of the confusion which has been created by the lack of sufficient definitional clarity to guide the industry, the Commission and the courts in adequately describing a leverage contract.

The Commission's Chief Administrative Law Judge, Eugene Hunt, has stated that the confusion of terms relating to so-called off-exchange instruments arises from the lack of definitional clarity in the Commodity Exchange Act itself. We agree.

Mr. Carabini has just testified as to the key elements of a leverage contract and I would agree with his comments and support his statement.

The issues which I have raised here are not unique or new to this subcommittee or to the Commission. Indeed, the very fact that many of these points have continually been the subject of much attention is the reason they deserve to be finally resolved in 1982.

The balance between industry concerns for clarity of regulation and the public protection to be afforded thereby present a strong imperative for the implementation of reasonable and clear regulations rather than continued delay and ambiguity.

Finally, Mr. Chairman, I would like to very briefly comment on two points raised in testimony yesterday by a representative of the North American Securities Administrators Association. First, the gentleman made reference to the fact that only four companies presently trade in leverage contracts. This is true. However, the CFTC-imposed moratoriums have prevented other firms from entering this business.

My testimony and the testimony of my colleagues is clear this morning, and that is that these moratoriums should be lifted once regulations are in place. No doubt new companies would then enter this market.

Second, the gentleman indicated that all off-exchange firms have opposed regulation. As our collective testimony has indicated, this is simply untrue. Nothing could be farther from the truth. Each of the firms represented before you today have previously sought regulations. We have submitted comprehensive proposed regulatory schemes. Indeed, even in the absence of formal regulations, each of us has separately maintained procedures and regulations dealing with matters as disclosure, segregation of funds, and complete hedging.

I appreciate the opportunity to appear before you and to make known our views on this subject and we would be happy to answer any questions.

Senator LUGAR. I deeply appreciate the testimony that each of you three gentlemen has given. In the testimony of Mr. Carabini and Mr. Simon, you made specific reference to what a leverage contract is. For the sake of the record as well as public understanding, I would like to try to establish what a leverage contract is, in a way in which each one of us on the committee—we are not sophisticated traders in leverage contracts—might understand so we could explain that to our constituents and to the public.

Obviously, one of the dilemmas, it seems to me, that you face and the frustration that you suggest and maybe the Commission has faced is that the character of the leverage contract is not well understood by many millions of Americans who have not been engaged in those transactions.

You mentioned some standard qualities. For example, a standard unit, quality, terms, and conditions, for the sake of argument—and Mr. Carabini has told us to begin with that his experience started with bags of coins. Can you describe that situation? That I think is understandable for all of us. How did you get started in this business? Physically what was traded?

Mr. CARABINI. A bag of silver coins is defined as $1,000 face value of coins minted prior to 1965.

Senator LUGAR. Why prior to 1965?

Mr. CARABINI. Those were 90-percent silver coins. We also offer coins which contain 40-percent silver minted after 1964 and because of their lower content in silver they cost, of course, less. The silver coin, as I mentioned, was the original commodity that we offered.

Senator LUGAR. Would these be dimes, quarters, or what?

Mr. CARABINI. Any denomination except silver dollars. They all contain the same amount of silver per dollars worth of value. From silver coins we then added to the commodity list silver bullion in 1,000-pound bars. After that, we offered—I am trying to recall, this goes back some 15 years—gold coins, numismatic coins primarily in bulk units of 20 coins or 100 sovereigns—Mexican pesos, for example, British sovereigns, and American double eagles.

Senator LUGAR. Let me just stop you there, Mr. Carabini, and ask why would I as a person coming into your store want to buy $1,000 worth of silver coins in a sack? What conceivable public or private purpose could I have in wanting to buy all of those coins? It is quite a bulky form. I do not know how big a bag that is, but——

Mr. CARABINI. Well, it contains 720 ounces of silver, with a bit of copper and it brings it up to about 800 troy ounces, which is about 55 pounds. It is about the size of a bowling ball, so you can get an idea of what the unit appears, how it appears.

The reason a customer would do so is because—one reason is inflation. During times of inflation, commodities such as gold or silver generally appreciate in value compared to the dollar. Over long periods of time, gold as you know and silver is a good proxy for goods and services in general. So as purchase power may decrease with the dollar, it sometimes stays level with commodities such as gold and silver. As we have experienced over the last 10 years, actually the silver and gold have appreciated in excess of the cost of goods and services in general, and I believe the primary reason has been the fear of inflation.

I think more recently there is greater fear of other economic conditions that may occur. Whether they be war or famine, although we ask the customer his intent, we sometimes are not able to determine the entire scope of his intent.

Senator LUGAR. In other words, the customer can either fear inflation or economic chaos in such a way that he would want to hold more of his assets in these coins. Now, why is the situation that you characterize different or what advantages are there to me in entering into a leverage contract as opposed to simply paying you $2,000, which is the value, the face value of these coins, and just buying them from you and giving you a check or currency of $1,000? Obviously, you get into a contract because I pay you less than $1,000 and I make installment payments apparently down the trail. What sort of a contract could we enter into if I just come into your shop to buy this bag of coins?

Mr. CARABINI. Let me give you an example. The $1,000 would be the face value of the coins. The market value may be $3,000, $4,000, or $5,000.

Senator LUGAR. You would state that? In other words, you would state a market value?

Mr. CARABINI. We make a market and each day we have a bid and ask price. The prices change some 20 to 30 times during the course of the day, which is about 11 hours, our trading day is about 11 hours.

Let us take as an example maybe $1,000 because it may be easier to relate to that. The amount of margin that would be required depends primarily on the price level of the commodity and the volatility of that particular commodity. Currently our required margin is 20 percent.

Senator LUGAR. You determine what level this is in your firm?

Mr. CARABINI. That is correct.

Senator LUGAR. There is no other overall margin requirement, there is no exchange. There are four firms and each one might determine what sort of downpayment that you require, is that it?

Mr. CARABINI. That is absolutely correct. The primary reason for the margin is to protect the company, because we hold primarily as security the commodities which the customers have purchased.

In this example, 20 percent would be $200 per $1,000. You would pay interest on the $800 remaining, the remaining balance.

Senator LUGAR. To you?

Mr. CARABINI. Yes, to us. We in turn would borrow from banks or other lending institutions the $800 so we in turn then really pass through to the customer. We do have—we attempt, I should say, to make a markup of our interest on a per annum basis of about 1 to 1½ percent. This has not been the case in the last 2 years because interest rates have gone beyond us, and also quite often currently Monex is able to finance most of its obligations itself with its own capital.

Senator LUGAR. Now, having paid 20 percent at the time that I—I am not in possession of the bag, am I? What do I do——

Mr. CARABINI. That is correct, we hold it.

Senator LUGAR. But I have a certificate or something that indicates——

Mr. CARABINI. You have the leverage contract itself. The leverage contract is the instrument pursuant to which the purchase is made.

Senator LUGAR. This contract obligates me to do what? At what time do I need to make more payments or do I need to take delivery or what further action is required of me?

Mr. CARABINI. The contract specifies that you must maintain adequate margin and the margin which prevails at any time. So if the leverage contract either raises its margin, you must increase your margin deposit. There is a minimum margin below which a margin call is made. A margin call must be met within 5 business days. If it is not met within 5 business days, the customer is in default and the leverage dealer has the right to sell out that position and remit to the customer whatever equity is in the account.

Senator LUGAR. So I could theoretically, if I was not called for more margin, just sort of sit there with this contract for a long period of time?

Mr. CARABINI. Yes, provided, of course, that you are making your payments of interest——

Senator LUGAR. On the loan.

Mr. CARABINI. Although I am not too sure of our competitors, but we send a statement out each month indicating the amount of interest that has accrued during the month. We do not really attempt to collect it. It is more expensive to collect small amounts of payments than to just add up on the books, but in the event, the account falls below minimum margin, which this would have an impact on because it would reduce the equity, then at that point the customer merely submits a new margin.

Senator LUGAR. So in a practical example, if the price of silver was going up and I have paid my original margin and the price of silver is going up, then I would not be called for more margin nor, at least in the case of your firm, would I have to pay the interest, in other words, given the fact that my equity presumably is rising?

Mr. CARABINI. Yes and no. On the first point, it is true, you would not have to put up any additional margin, but on the second point, it would have no impact on your interest because your interest is on the unpaid balance which has not changed. Your equity has increased but your unpaid balance remains with us.

Senator LUGAR. But I am still owing you $800, and the meter is ticking away on that presumably?

Mr. CARABINI. That is correct. In the example that I had mentioned earlier, the $1,000 with a $200 downpayment, if for example the value of that commodity went to $1,100, you would now have an equity of $300, your $200 that you had as your initial payment plus the $100 in equity. If it had gone down $100, you would have $100 in remaining equity.

Senator LUGAR. Would you be looking to me then for more margin?

Mr. CARABINI. It would depend on the prevailing rate, margin requirements currently that would trigger a margin call.

Senator LUGAR. All right. So the leverage aspect of this comes from the fact that, in this example, for $200 I have control over $1,000 of silver coins and in the event that these rise in value—for example, if they should rise in value by $200, give or take the interest involved, I might double my money?

Mr. CARABINI. That is correct.

Senator LUGAR. And the leverage means just that, sort of a five-for-one type of——

Mr. CARABINI. That's correct. And conversely, if it went down $200, you would lose——

Senator LUGAR. My investment would zero out. Now, why in your judgment has it been so difficult for the CFTC historically to come to grips with this situation? Obviously, you have been in business in this way, and if it had been an easy task, and in fact your hope is that the proposal made by the CFTC will not be adopted because that may shift the difficulty on to another educational round. Just from your own judgment as students of this industry over the course of your life, and you have dealt with many Commissioners now, many Members of the Senate and the House, how do you perceive this as a difficult problem? Why are we having this trouble with it?

Mr. SIMON. Well, if I might comment first, Mr. Chairman, it should not be a difficult problem. The Commission staff last year was directed to adopt regulations and they did draft a set of regulations. Each of the companies represented here, as I indicated in my statement, have also submitted drafts of regulations. The industry and the Commission are frankly not that far apart as to how they should be regulated.

The tough portion of your question to answer is why they have not really moved on it, and it seems to be administratively expedient to delay or to avoid coming to grips with it.

So it should not be difficult to come to grips with a regulatory scheme.

Senator **Lugar**. Well, is it an administrative problem, in your judgment, any of the three of you, or a political problem? You indicate that by and large attorneys have circulated back and forth sets of regulations and that you are not far apart, but you say it is administratively expedient not to come to a conclusion. Why?

Mr. **Groberg**. Mr. Chairman, going back into the history of the CFTC, I think that possibly—and I am rather new at the industry, only having come in in April, but I have done a lot of studying since then—I suspect that in the earlier years of the CFTC and in the earlier years of their education into our industry, and given some of the problems that occurred in some of the peripheral industries back in 1977, 1978, 1979, there may have been an honest concern on the part of certain CFTC staff members and certain CFTC Commissioners as to whether or not this leverage industry could in fact fulfill its obligations to its customers, or whether or not they were going to run into some of the same problems that they ran into with other industries.

I think that may have been a legitimate concern at that time, but I believe that the record now speaks for itself and that that concern should no longer exist. I think it is quite clear that this industry in many, many ways, including the complete segregation of the assets and the complete hedging of its positions protects its customers. And I might say as an added comment that we have been in business for 8 years and we served tens of thousands of customers and investors during that period of time, and during that same 8 years there has not been one single enforcement proceeding against IPMC by any State or Federal agency.

And so if in fact there was a concern at that time, if you were to look at the industry now, I am afraid that what has happened is a hardened position has developed out of an initial position and there is simply, for whatever reason I cannot determine, an inability in certain areas to change that position.

Senator **Lugar**. Well, indeed, you are probably right and yet at the same time let me just ask for the record whether the regulations that have been circulated, although not promulgated or adopted, meet that initial fear of the CFTC Commissioners or of Congress, either one, if indeed there are four firms now who represent responsible operations, as you have testified? Clearly, those records are good ones. Are the regulations that you are suggesting ones that are likely to lead to a sense of public confidence that others who might join you in the leverage industry would have the same standard of conduct? Are the regulations that you are suggesting that type so that in terms of your experience, in terms of your business practices, are you unique? Are you almost overcompensating to offer responsibility, to indicate something to the Commission that it did not see when it looked at this 8 years, 5 years or what have you, ago?

Mr. **Groberg**. Well, I think certainly we have overcompensated in the last several years in terms of our own procedures. On the other hand, I have seen two sets of regulations, preliminary regulations, suggested. One was submitted by the Commission staff itself, and the other was a set of regulations which the industry itself presented to the Commission recently. And I think in both cases the regulations would provide as much security as our customers have now, and certainly give the Commission all the authority it needs and all the confidence it needs that the customers of the industry would be protected.

Mr. SIMON. I would like to just briefly supplement the response, Mr. Chairman. In the absence of a formal regulatory scheme, each of the companies, while they may differ to degrees, have adopted regulations that are probably similar to or maybe even tougher than, as Mr. Groberg indicated, some of the things that are being talked about, and I would certainly think that the drafts of regulations that have been suggested either from the Commission's standpoint or those generated from the industry would be very cognizant and would have a very positive impact on the regulation of this business.

Senator LUGAR. In the discussion of futures markets during the course of these hearings, frequently the public policy and goals that have been suggested are those of price finding and hedging. As we have suggested, maybe there are all sorts of other goals, but in terms of reasons why the Federal Government becomes involved in this and sees these activities as desirable, those two come to mind right off the bat.

In the case of leverage contracts, how would you describe the public policy situation, as meaning those two things or are there other things that we ought to be characterizing as equal to hedging and price finding?

Mr. CARABINI. Well, the leverage contract is not really used for commercial hedging. It was not structured for that purpose. It is primarily the purpose of the futures markets. Second, it is not used as a price discovery mechanism nor risk shifting. Our customers assume the risk. So it is a different instrument and a different type of purchase.

Senator LUGAR. And this is what has led to a part of the problem, I suppose. But you are saying even though it is not a part of the futures industry and you do not want to be characterized in that way precisely, still you would like for this particular Commission, the Commodity Futures Trading Commission, to regulate you. Why? Why should it fall here?

Mr. CARABINI. Maybe I can cover just very briefly some of the history, because Monex preceded the organization of the CFTC by some 7 years. During that period of time, in the early years, of course, we operated primarily as a coin shop and a coin dealer. As we grew, States took different views as to how we should be regulated.

The State of California, for example, chose to view leverage contracts as a commodity transaction and regulated us accordingly. But most of the other States looked at leverage contracts as a security and a leverage contract is not a security, nor can it be treated as a security, and in most cases it was impossible to operate in those States. And as a result of all the confusion and the litigation that occurred, many companies were not able to stay in business, and those that did survive did so at great expense of litigation. I believe that was the reason for the inclusion of leverage contracts in 1974 in the CFTC act, to have jurisdiction to eliminate that confusion.

Senator LUGAR. What would happen in the event that all of your customers came to you and said we really do want to have the silver coins and we want to cart them away today?

Mr. GROBERG. I can comment on that as far as our—and it is somewhat analogous to what would happen if everyone came to a bank and wanted their time deposits. The reason a bank savings account is on a time deposit basis is to protect the bank against a run.

Our contract provides that we can delay for up to 30 days. That is our protection against something happening that would make all our customers come for delivery. I would say, however, that in the entire history of the company we have never delayed delivery. We have always delivered when asked. We in fact keep a store of bullion, coins, and our other products in both vaults on the company's premises and in vaults in the bank that is downstairs, so that delivery can be made immediately.

But the protection against the unlikely occurrence of a tremendous run, where we are hedging both in physicals and in futures and in forwards, is that you do have the right to delay delivery for that amount of time.

Mr. SIMON. The important point to be made in response to your question, Mr. Chairman, is that every single customer, because of the complete hedging activities which are undertaken by companies in the leverage industry, every single customer could pursue that which they had contracted for.

Senator LUGAR. Because you have hedged and therefore would be receiving delivery of whatever it is that you promised to give under your contract to the customer?

Mr. SIMON. That is correct.

Mr. GROBERG. Of course, the reverse occurrence, where everybody is selling out, I commented on before, that has occurred and we did meet our obligations in that case.

Senator LUGAR. Just for the record, you have mentioned a $7-million loss during the silver difficulty. Why would that have occurred? Can you describe the mechanism as to why those transactions lead to that kind of a loss for your firm?

Mr. GROBERG. There was such a huge inflow of orders and the market was in such chaos that we would sell out the positions as rapidly as we could, but that very frequently the market that we were selling out to was not extremely orderly.

Now, I was not there at that time. I cannot give you the technical details, but basically we did not have the legal obligation to make that market, but we did continue to make the market and we had great difficulty in liquidating those contracts.

Mr. CARABINI. I was there during that January and March of 1980 when, as you may recall, the price of silver during that 3-month period ran from approximately $52 I think into the teens, it was $18, a dramatic decrease.

There is always a question as to, although you do not have to make a market, you can discontinue selling. That is very easy. But when the customer wishes to sell back to you, although you have not guaranteed to buy back, in order to maintain yourself in a business you do so to accommodate the customer and we had customers, of course, selling out by choice, we had customers being forced out because their equity had decreased below wholesale levels. As a result of that, we had to buy back a great amount of silver and because of the illiquidity of the market we had to at times wait from 1 hour to 2 hours to 3 hours to liquidate those positions.

During those periods of time you can suffer great losses. And this goes back to the prior question as far as if the customers did come to us and asked for all of their bags or all of their bars or all of their gold, could we make delivery. We make delivery within 7 days, provided the customer has paid the balance in full, realizing that if all the customers came in they would have to pay for the unpaid balance. We maintain most of our positions and most of our cover in physical goods, but we always maintain 100 percent or nearly 100 percent of all our obligations in the metals. We segregate those metals in a separate entity. We also segregate in that entity equity equal to all of the customers' equity market-to-market each day, plus $1 million. So we have, as I may have mentioned earlier, may have gone overboard, although in our recommendations as to regulations I think one of the segments of their regulation should include adequate cover, adequate segregation of not only the cover, the metal itself, but also the equity of the customer. It should include appropriate disclosure of how the cover is maintained, and registration, for example, and a minimum capital requirement, and I would probably recommend a substantial minimum capital requirement. Those are the ingredients I believe that would help safeguard the customer's position.

Senator LUGAR. One final question. The North American Securities Administrators Association recommended concurrent State and CFTC jurisdiction over leverage contracts, and that may be the recommendation of the Roth committee, although that we will have to determine when we see their report. What is your comment on that situation?

Mr. SIMON. Mr. Chairman, the Roth committee touched on an area of commodity trading which is of concern to all of us, and I do not think that any of us here before you this morning would yield to anyone else in expressing our concern for the types of things that were described in those proceedings.

I do not think that a State can have or should have concurrent jurisdiction. As I stated in my statement, the CFTC has the commodities expertise. I have no way, I do not think any of us have any way, of knowing what States would do. As Mr. Carabini indicated, these leverage contracts are simply not securities, and that is not just a statement of position. The courts which have decided this issue, which have been faced with it, have so held that leverage contracts per se are not securities.

I think that the CFTC has the expertise and very simply that is where the exclusive jurisdiction should lie.

Mr. GROBERG. I have the same opinion.

Senator LUGAR. Gentlemen, I deeply appreciate your willingness to explain to the subcommittee so much about your business today. I think this is useful for our record and for our understanding and we appreciate your coming.

Mr. CARABINI. Thank you.

Mr. **Groberg**. Thank you, sir.

Mr. **Simon**. Thank you very much.

Senator **Lugar**. Let the Chair make this announcement: Senator Baker, the majority leader, has just sent out a call for all Senators to come to the floor very shortly. There probably will be a live quorum call and I suspect a very important, significant announcement in the life of the Senate. So at this point I would like for each of the three remaining witnesses, Mr. Clark, Mr. Fishman, and Mr. Ek, to come forward as a panel. We will attempt to hear you as rapidly as possible for the record because this hearing may terminate fairly rapidly, and you would not be heard if we could not hear you now.

Gentlemen, I appreciate your coming and we will attempt to proceed until we need to go to the floor for the business of the Senate.

I would like first of all to hear from Mr. Glenn Clark, a private attorney.

STATEMENT OF GLENN W. CLARK, GLENN WILLETT CLARK ASSOCIATES

Mr. **Clark**. Thank you.[1] It was 8 years ago, as the House and Senate were first considering the creation of the CFTC, that I appeared before the House in my then capacity as the superintendent of securities for the State of Iowa, and before the Senate as a law school professor of futures economics.

Four years ago I had the great pleasure and distinct honor of serving with this committee as a consultant on the occasion of the then reauthorization of the CFTC.

In a certain sense, I come today to say that an earlier optimism may have been, not unjustified, but overwrought—that there are problems associated with dealings in commodity related enterprises which are distinctly problematical. But I fear that, in an attempt to deal with very real problems, the proposals of both the CFTC and, though to a lesser degree, of the American Bar Association's Committee on Commodities Regulation, are overlooking or misapprehending a very fundamental problem—the distinction between futures markets, on the one hand, and cash forward contracts or markets, on the other.

The misapprehension is deep and profound. I recall just this last week that Newsweek magazine, in a totally unwarranted attack on the Kansas City Board of Trade's new stock index futures contract, tried to tell us that stock prices were less volatile than commodity prices. This is, historically, simply not true.

Commodity prices are not more volatile than stock prices, which are discovered in a cash market. The great difference stems from the fact that there is an incredible degree of leverage associated with commodity futures operations not common in dealings in shares.

The operation we have just been diagnosing in the last few minutes, the leverage contract, is quite frankly an attempt to import a large but less-than-futures degree of leverage to a commodity cash forward contracting operation. The crucial distinction is, and remains, though the CFTC will not now see it this way, that the futures business is almost totally, exclusively, and solely what takes place at the Chicago Board of Trade, the Chicago Mercantile Exchange, and other like institutions.

---

[1] See p. 690 for the prepared statement of Mr. Clark.

The existence of the clearinghouse, the existence of the competitive market, and the multiplicity of the buyers and sellers makes the futures market. There are other markets, and they present other problems, but the CFTC should not attempt to deal with those other problems under the rubric of futures, for in doing so it sullies the good name, the ancient honor, and the impeccable historical record of authentic futures trading.

This confusion stems in some large part from the fact that the traditions of cash-forward contracting are very different when you are talking about different commodity classes.

Europeans have vast experience with precious metals and with financial instrument futures contracts of a sort that we have simply not experienced in this country in most of the last 50 years. Part of the problem that the CFTC wrestles with, honorably, fairly, but with some degree of misinformation, stems from the fact that this ancient history is not known to them, or if known, is suppressed.

Particularly, precious metals have a different history. Part of the problem in 1974 was to deal with the very different tradition of dealing in precious metals. Section 217, the attempt to deal with leverage contracts, is an illustration of that sort of approach.

But, in the interest of time, let me simply state that perhaps the major problem presented by the accord which generates this legislative proposal is not in fact in the text of the act that is before you. More profound problems, I suspect, will be presented to the Committee on Banking, Housing, and Urban Affairs when proposed amendments to the securities laws are undertaken. Some of those, the product of this accord, are truly monumental—extending jurisdiction to the SEC over all options on certain nonsecurities. I do not know if they intend this as a vast power grab, but it is that.

If you wish to give that power and jurisdiction to the SEC, be my guest. It is an arguably sound proposition that SEC jurisdiction should be expanded. Do not, however, be lulled into the sense that this act, as it will appear before either committee, is a mere codification or clarification, or that no agency self-interest is involved. Self-interest of both agencies is very much involved. This legislative revision could extend to housing finance, to banking, and to mortgage markets in ways that are unintended and perhaps very disruptive.

What to do? May I suggest that a reasoned basis for asserting CFTC exclusive jurisdiction is quite simply that is applies when we are dealing with authentic exchange—based dealings, and operations ancillary thereto. Hence, exclusive jurisdiction exists in the CFTC over all futures; and over the managed accounts which exist to deal in futures; and over the commodity pools which exist--at one step derivatively removed—to deal in futures. A theoretical justification for exclusive jurisdiction over the leverage contract is also that the leverage contract operation may be, in the words of the inimitable Stanley Sporkin: "the jobbing of futures."

Now, the leverage contract, a generic cash-forward contract, is more than that, and practical reasons for giving the CFTC exclusive jurisdiction over this phenomenon are strong and real. If, however, the legislative judgment is to be made that the several States ought to be cut into regulation of leverage contracts, I could not theoretically assert that this is something which would cause the republic to fail; but I will assert strongly, that if the several States are cut into the business of regulating authentic exchange-based futures and the instruments directly ancillary thereto, yes, indeed, perhaps not the Republic, but at least, a very important industry for agriculture will be harmed irreparably.

Thank you.

Senator **Lugar**. Thank you, sir.

STATEMENT OF GERALD L. FISHMAN, REPRESENTING DOWDEX CORP.

Mr. **Fishman**. Thank you, Mr. Chairman, I am Gerald L. Fishman, a practicing attorney in Chicago, and I am before you today on behalf of my client, Dowdex Corp., a dealer in precious metals which has been in the business of granting options on gold since the mid-1970's.

In the written statement which I have submitted for the committee's consideration, a proposed amendment to section 4c(d) of the Commodity Exchange Act is contained.

Before I summarize my written statement, allow me to tell you a bit about myself.[1] I am a 1966 graduate of the Northwestern University's School of Law. My practice has concentrated both in the securities and commodities areas as well as in the area of corporate finance. I am a member of both the Securities Law Committee and the Commodities Law Committee of the Chicago Bar Association and have served in various capacities on both committees, including having served as chairman of the commodities law committee. I have also written a number of Law Review and other articles and have lectured in various areas, principally securities and commodities, and I am a member of the American Bar Association's Committee on Commodities Regulation as well.

Briefly, the thrust of my submitted written statement is that generally CFTC regulation of the dealer options industry so far has worked well. To be sure, the provisions of current section 4c(d), together with CFTC foot dragging, so to speak, has substantially limited the size of the industry and the products dealt in. Nevertheless, I think there has been sufficient positive experience with the industry to indicate that it can and should continue without fear of debacles which were perceived in other types of commodity options in the early and mid-1970's.

As you may know, in response to the congressional mandate of 4 years ago, the CFTC has had certain amendments to its dealer options regulations proposed for almost 2 years. It is in connection with those proposed regulations as well as the opportunity to revise the statutory provisions relating to dealer options to which the two substantive items of my statement are addressed.

---

[1] See p. 679 for the prepared statement of Mr. Fishman.

First, I would respectfully suggest that the CFTC be congressionally directed to rescind its rulemaking dealer options granters jointly and severally liable for fraud or misrepresentation of a broker selling that firm's options without due process of law.

Under the current rules, if a broker acting for its customer commits fraud in connection with a dealer option and the broker is found liable to the customer for that fraud, the option grantor firm automatically is jointly and severally liable even though the grantor has nothing to do with the fraud.

The perceived necessity for giving customers an additional deep pocket in those cases simply has not come to pass. In my view, fairness as well as the due-process clause require that dealer option grantors should not be subject to joint and several liability for violations not their own.

Second, I believe Congress in enacting section 4c(d) 4 years ago understood that firms granting dealer options are not commodities brokers. They are business enterprises which trade and deal in commodities and grant options on those commodities as well. Indeed, by long-standing CFTC regulation predating the 1978 options ban, commodities brokers are prohibited from granting options.

The congressionally mandated net worth, total assets minus total liabilities, minimum required for entry into the dealer options business makes eminent good sense. The intended additionally restrictive CFTC proposed net capital requirement for option grantors does not. It would seem to me that financially regulated service organizations such as commodities brokers or securities brokers clearly are susceptible of net capital requirements in addition to net worth to insure the integrity of their operations. This is clearly not necessary in the case of dealer options grantors since they are commercial rather than service organizations, and in light of all the other safeguards already built into the statute and the attendant regulations presently in effect.

So as not to overregulate the area, I respectfully suggest that Congress in effect direct the CFTC to take cognizance of these differences and not simply lump options grantors with brokers in the agency's scheme of regulations. I believe this can be accomplished by the language suggested in my written statement.

I hope I have been clear concerning these two issues. As I mentioned, a proposed amendment to section 4c(d) addressing these issues is part of my submitted written statement and I, of course, would be pleased to respond to any questions that the Chair may have.

Thank you.

Senator LUGAR. Thank you very much, Mr. Fishman.

Mr. Ek, would you please testify.

STATEMENT OF CARL W. EK, LEGISLATIVE ASSISTANT, NATIONAL FARMERS UNION

Mr. EK. Yes, sir. Good morning, Senator. My name is Carl Ek. I am legislative assistant for the National Farmers Union. We appreciate having the opportunity to testify today and we also are grateful for your accommodating our time requirements at this point.[1]

The principal concern of the National Farmers Union in this, as in most other issues, is that the interests of the family agricultural operation be both protected and promoted.

The NFU feels that in the 1980's producers may increasingly turn to futures contracts as a marketing tool. As farmers attempt to ride out the current tide of recession and high interest rates, the price insurance offered by hedging is becoming an attractive alternative to the cash market and our interest in these reauthorization proceedings is therefore a keen one.

The first and most important question of these hearings is whether or not the reauthorization should take place at all. With the creation last year of the National Futures Association, the futures industry now has in place an organization which, some claim, would allow the industry to become self-regulating and the CFTC to simply melt away.

This argument cannot be accepted uncritically. It is, after all, in the strongest interests of the NFA's members that the integrity of the market be preserved. We trust that they will work to guard against the loss of confidence in the market which would be caused by serious irregularities.

Eventually, the NFA may be able to assume some of the regulatory functions now exercised by the CFTC, such as auditing and registration. For the time being, however, the National Farmers Union views the Commission as the best form of insurance the public has to assure that the market will continue to operate in as nearly a state of perfect competition as possible. Its operations preclude the conflict-of-interest potential suggested by complete self-regulation.

In the interest of time, I am going to skip some part of my statement, sir.

We support the Commission's two-part proposal that it be permitted to share evidence and information with State law enforcement agencies, and that those agencies be authorized to prosecute certain commodity fraud cases under their own laws. In conjunction with this, we recommend that the Commission's Office of the General Counsel review existing State laws to determine whether they are at least as adequate and stringent as the Federal statute. We believe that such Federal-State cooperation would serve the dual purpose of accelerating the judicial process as well as easing the strain on the Commission's resources.

Perhaps the most controversial issue in the reauthorization process is the CFTC's recent proposal that it become a self-funding operation through the imposition of user fees. The National Farmer's Union is strongly opposed to this for two major reasons.

In the first instance, we seriously doubt whether the full cost of user fees can readily be absorbed either by the floor brokers or the futures commission merchants for whom they trade. We believe that user fees, like any other externally imposed expense in the marketing system, will ultimately settle upon the producer.

---

[1] See p. 691 for the prepared statement of Mr. Ek.

A second major objection we have to the levying of user fees is the tacit assumption of the administration that, like the owners of yachts and private planes, participants in the futures markets should shoulder the entire financial burden of the Federal supervision provided them. This argument might have a sound basis if those who actively trade were the sole beneficiaries of the Commission's services. However, we believe that by facilitating orderly trade, the Commission is providing a public good, the benefits of which accrue to the whole of society.

For these reasons, we regard the user fees as both disruptive and inequitable for those in the agricultural sector, and income regressive for consumers.

Another area being debated in these hearings is that of the Commission's so-called emergency powers. The NFU believes that the Commission should retain the ability to quickly intervene in the market in response to severe disruptions. In the past, such emergency powers have been exercised only as a last resort to worsening noncompetitive market movements. The exchanges possess certain emergency powers themselves, and the CFTC has never prevented exchange use of such powers.

Last fall the Commission granted its approval of a pilot program in options trading. The Commission now apparently feels it can develop the capability to effectively monitor trading in options contracts to the same degree that it handles futures. Additional rules, they claim, can be "folded into" existing regulatory structures.

The limited liability aspect of options has promoted several agricultural economists to suggest that option contracts on agricultural commodities might prove to be a useful risk management device for producers.

We trust that the subcommittee will allow the current program to run its course before opening up the field any further. During this trial period, the Commission will have ample opportunity to gather information on financial instruments options, and then assess the probable effect such trade would have in agricultural commodities. We urge the subcommittee to request of the Commission a final report which would evaluate the performance of options traded.

On the remainder of the proposals contained in the Futures Trading Act, we defer to the subcommittee's good judgment as to the effect upon the family farm.

Thank you.

Senator LUGAR. Thank you very much, Mr. Ek.

Let me followup the latter part of your testimony by asking these questions. I share your concern that agricultural options should not be offered prematurely because this might be adverse to the farmer. But even if the ban on options is lifted, the CFTC would still have to study and approve them before they could be offered to the farmers. As long as the CFTC retains control, is there any harm in repealing the statutory ban against options, as the USDA suggested yesterday?

Mr. EK. I do not think there would be any harm if the study of the pilot program did prove that this would serve a good economic purpose. We think that is a central issue here.

Senator LUGAR. Would there be any benefit in testing agricultural options as a part of the current pilot program? Do you support that essentially?

Mr. EK. As a part of the current program, we think it is a bit premature.

Senator LUGAR. Let me go back to some comments that you made, Mr. Clark. In your written statement it appears you are opposed to the CFTC/SEC agreement, but maybe not——

Mr. CLARK. No, not quite.

Senator LUGAR. That may be an incorrect inference. Let me ask you to state further what you feel on that subject.

Mr. CLARK. I do not believe that the accord represents the theoretically most principled division of labor between the two agencies. To be specific, I believe that clearinghouse offset options of any sort, whether they call for the intermediation of a futures contract formation and discharge, or whether they merely call for a bookkeeping settlement—as is presently conducted by CBOE and OCC, are in fact futures contracts, as they always have been.

Now, I immediately add that I think the New York Stock Exchange—I know the New York Stock Exchange conducted a futures operation in individual equities prior to the devastating experience of the Great Depression.

I know that it was understood then, as late as 1932, in the Congress, that the New York Stock Exchange had futures on individual equities.

We had chosen as a matter of national policy to back off from high leverage investments in cash markets. Now, once the SEC was persuaded that they could go with a CBOE options program, what they were really saying is that they would abandon the premises of 1934 and 1935 laws, and that higher leverage is indeed an OK thing in securities markets as well as in commodities.

I think the proper line of division, frankly, would have been to say that certain things are not commodities, to wit, individual industrial equities are not commodities. I think that is the amendment that is needed in the Commodity Exchange Act.

I am of the view then that all of these option arrangements are futures. I leave it to political judgment to determine how they should be allocated. I cannot defend—I believe the proposition indefensible that there is a distinction between clearinghouse offset options on futures and clearinghouse offset options on actuals, and I foresee a never-ending morass with the lines drawn as they are by the accord.

I appreciate, however, the practicality of the situation, which is that you do not fix something that is not broken. CBOE works. Let it be. If CBOE wishes to engage in an options operation which substantially duplicates, as I believe it does, the proposals of the Chicago Board of Trade, and the existing Chicago Board of Trade Ginnie Mae and other financial instrument futures markets, again, let that be a political judgment; or, better still, let them both at it and may the best man win.

In that regard, I would second what Mr. Ek has said, why not get Congress out of the business of attempting to prohibit anything a priori? Why not concentrate enforcement activities not on the sterile question: Are you the wrong species? but, instead, on the meaningful question: Are you ripping off the public? Prosecute for fraud when there is fraud, because there is fraud, not on the question: Is this a prohibited commodity option? is this a prohibited "off-exchange future"? To divide the world between the two agencies, as the accord does, is a good day's work, and probably deserves to be supported. Let it be.

Senator LUGAR. Let me ask, without trying to characterize your prepared statement, what is your judgment on user fees?

Mr. CLARK. My judgment is that it is most unfortunate that the label user fee is even applied here. I am uncomfortable in opposing user fees. I oppose no true user fee. I would tax the owners of private yachts mercilessly. I would make people who tie up their private airplanes at FAA airports pay and pay through the nose. Let operators pay for going through lock No. 26 at Alton, Ill.

This is not a user fee. It is just not a user fee. It is a tax. The exchanges produce prices as a free good to farmers and industrial users. Perhaps, indeed, the exchanges should ask for a subsidy instead of being asked to bear a tax. I think it is frankly, simply, a device to make the CFTC more like the Comptroller of the Currency or the Federal Reserve Board, self-funding, self-supporting, easier to justify an empire building. I plead with you, No. 1, do not let them build an empire; No. 2, do not tax or bring it about.

Senator LUGAR. Mr. Fishman, do you have a thought on the user tax, the user fee question?

Mr. FISHMAN. I wholeheartedly support what Mr. Clark has just said. I consider it in my view to be a tax and I think that the user fee label, as Glenn has just said, is really the wrong label and I think it bears tremendous scrutiny. It does not seem to fit for what is trying to be accomplished in terms of the industry and the regulation of the industry.

Senator LUGAR. Mr. Fishman, it is my understanding that the net capital rules under consideration by the CFTC which would apply to the dealer option grantors are not final regulations. Have you discussed the concerns that you have expressed today with Chairman Johnson or the CFTC staff; if so, where do you stand with them?

Mr. FISHMAN. I have not discussed it directly with Chairman Johnson, but prior to his ascension, when the proposal was initially published in the Federal Register, we did submit written comments specifically on this issue, and as far as I know it is somewhere in the morass of the staff of the Commission. I have not heard about it, although the last thing I did hear was that the Commission was talking about bringing that to the fore sometime this quarter, but so far that has only been a rumor.

Senator LUGAR. What provisions do you now have in place to assure that you will have the means, have the money to honor a dealer option contract if the price moves against you?

Mr. FISHMAN. There are two basic requirements presently involved, one on the FCM that is selling the option to the public, and the second on the dealer option grantor. The FCM that is selling the option to the public receives the premium and maintain that premiums in a segregated mode for the balance of the life of the option until it expires or is exercised or is abandoned. At that point it gets paid to the dealer option grantor.

Second, the dealer option grantor, in addition to his own hedging either through the physical commodity which he is granting an option against or in the futures market, is required to maintain a daily mark to market of the profit, if you will, of the individual option, so that there is always a fund or a pool of funds to satisfy the requirements of the dealer option grantor.

Senator **Lugar**. What practical impact would the proposed net capital regulation have on your clients?

Mr. **Fishman**. It would have a significant negative impact in that it would negate from the standard net worth computation of a commercial enterprise. Those assets which the CFTC would take the position are not good assets, whereas under generally accepted accounting principles those assets not only are good assets but are capable of liquidation on some relatively quick basis.

The problem seems to be that the CFTC takes the position that the assets of the dealer option grantor must be similar to those of a broker in that they must be liquidated very quickly, and if they are not liquid in form that they are not good assets. Well, that simply is not the case, nor is it the way that American business generally operates. And the American Institute of Certified Public Accountants, of course, the keepers of all of our books, has recognized that there are assets that, while not that quickly liquidated, are still valuable and still have a value and a basis upon which American business can go ahead and deal.

Senator **Lugar**. In the area of joint and several liability, your prepared testimony indicates that there have been very few customer problems in the area of dealer option sales. If that is so, is the CFTC regulation providing for joint and several liability really a problem? And what particular problems has Dowdex experienced in the area and what was the dealer option sales area like before the regulation was promulgated and made final?

Mr. **Fishman**. Well, the regulation itself has not been a problem for Dowdex nor has it been a problem I think for any of the other option grantors that fall under section 4c(d) in its current form, simply because, not surprisingly, as I said in my written statement, there have not been that many problems whatsoever that have arisen. Of course, I am sure there may be two or three or whatever customer complaints as there are when there are thousands of customers in any business. You are not going to have 100 percent satisfaction.

You are correct, Senator, in saying that there have been no problems with this. The problem that exists is that I think it is there in a form which to my mind is contrary to the constitutional due process provision, and the potentiality for a dealer option grantor being caught in this web of joint and several liability without the ability to defend itself for something it has not done is sitting right there on the books, so it seems to Dowdex and to me that it really is inappropriate. It was originally adopted as a regulation in the heat of battle, if you will, after the major embarrassment of the Lloyd Carr scandal, and it seems to me it has no place in American administrative or judicial parlance at all.

Senator **Lugar**. Mr. Ek, I gather from your testimony that the National Farmers Union favors reauthorization of the CFTC. Am I correct?

Mr. **Ek**. Yes, sir.

Senator **Lugar**. Some witnesses have testified that judicial review of the Commission's use of its emergency powers is vital in order to provide a check on this power. Since the National Farmers Union has a contrary position, or at least it appears to me that it does, how would you respond to testimony on this issue?

Mr. **Ek**. We feel that in a nutshell judicial review is equal to no emergency power, that having this Damocles sword above the Commission's enforcement capability would perhaps even further—cause further delay and hesitation in the usage of the emergency powers.

We feel in addition that they have not been exactly trigger-happy in using these powers.

Senator **Lugar**. Would you be willing to have some private entity or other Government agency study the utility of trading with agricultural options along with or in lieu of a CFTC study?

Mr. **Ek**. Yes; we would——

Senator **Lugar**. You would have no objection?

Mr. **Ek**. No objection at all, sir.

Senator **Lugar**. Mr. Clark, one final question. Your testimony theoretically stakes out the rationale or philosophy for futures and for what this agency ought to do from your own experience. If you can characterize the present situation as we proceed in reauthorization, what type of legislative changes ought to be envisioned? I don't ask for a response in detail, section by section. But as we look at the package offered by the CFTC to the committee, which is the underlying basis for this hearing, and other changes that have been suggested by the industry, which may or may not be introduced in legislative form, what general advice and counsel can you give us—in addition to staking out of what we ought to be about—so that in a practical sense we might avoid the pitfalls that you foresee?

Mr. **Clark**. There are highly practical reasons for implementing the jurisdictional accord. Whatever my theoretical quarrels with that on either side, there is a compelling reason for letting people get on with honest business.

I believe the CFTC would be a happier place today and would have been a happier place at all times if it had understood that its cardinal operating arm is its division of trading and markets. In fact, almost nothing else in its regulatory establishment needs to exist or is theoretically entitled to exist.

Senator **Lugar**. Let me ask you this point, because we had just before your appearance the people in the leverage business. Now, should the CFTC promulgate regulations for those firms, or if not, who?

Mr. **Clark**. My rationale, as stated earlier, is that there are activities, so closely related to activities immediately productive of futures market activity, that need to be regulated by the same Commission—probably because the CFTC, alone, among agencies, could be expected to understand these symbiotic relationships. But the theoretical ground for CFTC exclusive jurisdiction, I do believe, can only be that we are talking about some direct relation to exchange-formed contracts.

Here is the crucial difference between commodity futures and securities in this regard: Securities, you see, are sold over the counter. The New York Stock Exchange is merely a secondary market, and what happens there adds not one jot or tittle to a new company seeking to sell a new issue, thereby to go out and build a press or implement new ideas. Securities are sold. Securities have a very real existence as something that can be bought and sold.

There is no secondary market for futures, nor is there a secondary market for CBOE options. All that is happening is that you are forming and discharging executory contracts calling for a highly theoretical future performance that almost no one ever expects will be acted upon.

I think the SEC, quite frankly, is the proper agency to deal with generic garden variety fraud in the financial world in investments, flyers, speculations and rip-offs of all sorts. I fully support the plea of my sometime brethren, the State securities administrators, that they and the SEC are undoubtedly the best cops on that beat.

A corollary of that is that the CFTC ought not persist in embarrassing itself in claiming a jurisdiction it can ill claim and seeking to do something it can ill afford—in seeking exclusive jurisdiction over off-exchange forward dealings that it cannot possibly master with its budget and its capability.

In general, I would suggest that you narrowly implement the accord but go very, very easy on anything else. Specifically, do not, absolutely do not touch the current forward contract jurisdictional provisions. Do not tinker, as various people have suggested you might, with section 4 and section 4h. To vary that is to become involved in a very complicated question now before the courts. I ask leave to submit an additional paper on that question, but I think all you can do, eventually, is what Louis Loss has been trying for 10 years to do with the securities code, to sit down and really think it through carefully, with superbly qualified non-Commission advisers, over a period of several years.

Senator LUGAR. Thank you very much for coming today and being so forthcoming in your responses.

The Chair would announce that the American Farm Bureau board of directors has adopted a proposal in support of a pilot program in agricultural options. They have released a statement and have asked that it be included in the record and, without objection, that statement of the American Farm Bureau Federation will be put in the record.

[The following proposal was received by the committee:]

On March 9, 1981, the Board of Directors of the American Farm Bureau Federation adopted the following recommendations pertaining to trading in agricultural options:

(1) That Farm Bureau seek to amend the Commodity Exchange Act by eliminating the specific prohibition against trading in domestic agriculture commodities.

(2) That options trading in domestic agriculture commodities be included in the CFTC three-year pilot program. That the CFTC include in the pilot program agricultural options on commodities traded on the Minneapolis Grain Exchange and New Orleans Commodity Exchange and, more importantly, on the Chicago Board of Trade and the Chicago Mercantile Exchange.

In order to carry out the first recommendation, the Commodity Exchange Act should be amended by deleting the words, "but not specifically set forth in Section 2(a) of this Act" in paragraphs (b) and (c) Section 4c, and by deleting in it's entirety

Subsection (B) of Section 4c. This will allow options trade in domestic agricultural commodities.

Trading in agricultural options may be an important marketing tool for farmers, particularly during periods of market volatility. Farmers will be allowed to benefit by price fluctuations while protecting themselves against potential losses.

Options, then, may be used as price insurance to assure a maximum or minimum price for an anticipated purchase or sale of a commodity in the future. The cost of this price insurance is an option premium which is determined when the option is purchased.

Options trading can be an effective risk management tool by limiting farmers' vulnerability to market fluctuations. The only liability a farmer faces is the option premium which is calculated and paid at the time the option is purchased. A producer makes a management decision as to whether the premium is reasonable in terms of the risk of price movement and the price protection provided.

From 1970 to 1981 the percent of agricultural contracts traded on the exchange declined sharply from 90 percent to about 50 percent. Excluding trade in domestic agricultural options may hasten this trend to the disadvantage of the producer. Allowing options trading in nonagricultural commodities may cause speculators to discontinue trade in agricultural commodities because options may offer better controlled gambles than futures. Options would allow speculators as well as producers an opportunity to minimize loss and maximize gain. A decrease in speculative trade could adversely affect market efficiency and market liquidity. Agriculture also needs to keep abreast of changes in the industry to keep our markets viable.

There is considerable hypothetical evidence about the pros and cons of options trading. We feel that a logical solution to the debate is to allow domestic agricultural commodities to be included in the CFTC's three year pilot program of testing the feasibility of trading commodity options on domestic boards of trade. This pilot program will give the emperical evidence which is necessary to better evaluate options trading.

Senator LUGAR. Has Mr. Rosenthal arrived?

Mr. Rosenthal will not be arriving. His statement, by unanimous consent, will be made a part of the record.[1]

That concludes this hearing.

Thank you very much.

[Whereupon, at 11:45 a.m., the subcommittee adjourned, subject to the call of the Chair.]

---

[1] See p. 685 for the statement of Mr. Rosenthal.

APPENDIX

STATEMENT OF HON. DAVID BOREN

A U.S. SENATOR FROM OKLAHOMA

Mr. Chairman, the hearings that you have convened to receive testimony on the reauthorization of the commodity futures regulatory program are important for two reasons.

First, a number of amendments to the Commodity Exchange Act--the statutory authority for the Federal regulation of futures trading--have been proposed. The Commodity Futures Trading Commission has recommended a comprehensive set of improvements to the Commodity Exchange Act. The futures industry has developed a draft bill to provide what the industry describes as a framework for a much-needed modernization of the Act. I am sure that we will receive additional proposals for amendments from the many witnesses scheduled to testify.

I look forward to receiving the views of the commission, the industry, farm organizations, the General Accounting Office, and others on the various proposed amendments.

In addition, I hope that the hearings will enable us to focus on basic issues relating to reauthorization of the Federal regulatory effort.

The futures industry has experienced dramatic growth over the last decade. The sheer number of futures transactions has skyrocketed, and trading has begun in a diverse number of new futures contracts.

There is no doubt that the futures industry is becoming an increasingly major segment of our nation's economy.

The hearings--and the reauthorization process, generally--give us the opportunity to consider:
What role futures trading plays in our commercial and financial economies; the nature and effectiveness of the self-regulatory mechanisms in the futures industry; and the type and extent of Federal regulation that is needed.

I want to thank the chairman for developing a comprehansive hearing schedule, and am delighted that we have Philip Johnson, the Chairman of the Commodity Futures Trading Commission, with us today to lead off the hearings.

SUPPLEMENTAL STATEMENT OF PHILIP McB. JOHNSON, CHAIRMAN
COMMODITY FUTURES TRADING COMMISSION
BEFORE THE
SUBCOMMITTEE ON AGRICULTURAL RESEARCH AND GENERAL LEGISLATION
OF THE SENATE COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

Mr. Chairman and members of the Subcommittee, in this supplemental statement, I would like to discuss in detail the principal recommendations the Commission is making for what we view as improvements in the Commodity Exchange Act. The legislative proposal containing these recommendations, which we previously submitted for your consideration and which has been introduced in the Senate as S. 2109 and in the House as H.R. 5447 is, as you know, a lengthy and somewhat formidable document. That legislation, however, is the product of careful analysis of our experience under the Act and of our determination to contribute to the "sunset process" our best efforts at self-improvement.

Although the bill we recommend may appear complex, the goals it seeks to achieve are not. Indeed, we believe that the proposal will be a major step toward simplifying and streamlining procedures, will help resolve questions of the interacting responsibilities conferred upon the Commission and the Securities and Exchange Commission, and will pave the way for more and better self-regulatory programs under the Commission's oversight. For the most part, the bill is not intended to confer any new powers or to spawn major new regulatory burdens. The bill is intended to:

(1) Improve the delivery of important services by the Commission to the public;

(2) Facilitate the administration of our oversight functions;

(3) Confirm the responsibility of the several sectors of the commodity industry for its self-regulation and provide guidelines for the assumption of those self-regulatory functions;

(4) Equalize the impact of existing regulations;

(5) Encourage prudent business practices; and

(6) Bring resources outside the agency to bear upon the difficult task of law enforcement by (i) encouraging the States and other governmental authorities to participate in the elimination of unlawful off-exchange commodity transactions, (ii) permitting the sharing of

certain investigative information, and (iii) increasing the access of the public to various forums in which to seek redress for their legitimate claims and grievances.

Allocation of Jurisdiction.

The Commission's proposal contains amendments to the Act which would be required to codify the jurisdictional accord reached with the Securities and Exchange Commission on December 7, 1981. It also extends an invitation to the States to enter the effort against off-exchange activity.

CFTC-SEC Jurisdictional Accord. The joint CFTC-SEC legislative recommendations attempt to provide the marketplace with the freedom to choose the kinds of instruments best suited to the needs of our economy. When we agreed to settle our differences regarding regulatory jurisdiction, Chairman Shad and I had three basic objectives. First, we intended to eliminate the jurisdictional hostility between the agencies that had hampered both the commodities and securities markets in developing new financial instruments. Clearly, both industries deserve a level of certainty about who may trade what and when. The desirability of a resolution by the two agencies had become increasingly pronounced and was, as you know, one of my primary concerns when I first took office as the Chairman of the CFTC, at a time when the unseemly confrontation between the two Federal agencies had spilled over into the Federal courts.

Our second objective was to avoid upsetting the status quo in the marketplace. No demonstrable public benefit could be derived by changing the rules of trading in existing and viable markets.

The third objective was to maintain, to the extent practicable, the traditional roles of the two agencies. That is, the CFTC would regulate markets and instruments that served a hedging and price discovery function and the SEC would regulate markets and instruments with an underlying investment purpose. The key was to preserve the traditional regulatory expertise of both agencies.

These three objectives have in my view been accomplished and are the appropriate frame of reference for an appraisal of our proposed amendments to the Commodity Exchange Act. The agencies have, as you know, submitted a joint explanation of the respective legislative proposals which describe the contents of the agreement in greater detail. I will not attempt to repeat that exposition here. In broad outline, however, the CFTC and SEC have agreed: 1) to leave completely intact the CFTC's exclusive regulatory jurisdiction over all futures trading and all options on futures on all commodities; 2) to continue SEC regulation of stock options; 3) to specify that the SEC would regulate trading in options on securities, including exempted securities, such as debt instruments issued or guaranteed by the U.S. government, options on certificates of deposit, and options on foreign currency when traded on a national securities exchange; 4) to continue the CFTC authority to regulate options on foreign currency when not traded on a national securities exchange; 5) to make explicit that CFTC exclusive jurisdiction over commodity pools does not remove the applicability of certain aspects of the Federal securities laws to securities issued to the public by commodity pools; and 6) to reserve for further study the appropriate jurisdictional framework for futures contracts on individual corporate or municipal securities.

We also agreed to resolve our differences with respect to stock index futures. Traditionally, the SEC had expressed concern that trading in such a futures contract would have an adverse impact upon the nation's equity markets as well as the SEC's ability to ensure manipulation-free securities trading. The CFTC's sensitivity to this concern is reflected in the structure agreed to by the agencies for considering designation applications for stock index futures. Our agreement preserves the CFTC's exclusive jurisdiction over the decision whether to permit such a futures contract to be traded, but at the same time insures that any concerns expressed by the SEC will be considered carefully by the CFTC. In essence, the CFTC will designate a stock index futures contract only if the contract, in addition to satisfying the existing designation guidelines for all other futures, is on a "broad-based" index predominantly composed of the securities of unaffiliated issuers, provides for delivery in cash or via an exempted security, rather than the actual delivery of securities, and is not readily susceptible to being used in the manipulation of the price of any underlying security or option on such security.

I am confident that the division of regulatory responsibility set forth in this joint legislative recommendation will serve well the interests of both the futures and securities industries as well as the trading public.

In fact, new financial instruments held hostage by the jurisdictional debates of the past have already been approved by both agencies. Ultimately, of course, the forces of the marketplace will determine which new instruments will succeed in providing useful economic benefits to the wide range of financial institutions that have been awaiting the availability of new trading tools to limit risks and provide greater certainty in financial management. While the CFTC will continue to examine closely the potential economic purpose of each new futures contract, I believe that the marketplace best judges which instruments are most useful to it at a particular time.

There are those who contend that the CFTC "gave up" too much in this agreement. There are an equal number of voices arguing that the SEC made too many concessions. This, in my view, signals that we have struck a healthy and equitable balance. It is well recognized that in any successful discussion each side must bend a little in recognition of the positions held by the other side. This agreement is no exception. What is important, however, is that both agencies desire to make the agreement work and that both recognize that the public will be better served by eliminating the jurisdictional questions which existed before the accord was reached. I strongly believe that this agreement will accomplish our mutual goals and urge Congress to enact our legislative recommendations in their entirety.

Expanded Role for the States. In recent years we have witnessed a trend to fraudulent operations with a "commodity" theme. It is increasingly apparent that the Commission, with its limited budget and resources, cannot possibly put a stop to these frauds if it is the only cop on the beat. Present Section 6d of the Act authorizes State officials to seek injunctions or civil damages in Federal court against commodities law violators. It also recognizes that State officials may sue in local courts under their general civil or criminal anti-fraud laws. Because of certain statutory and practical impediments to full State participation in the law enforcement process, however, State actions under Section 6d thus far have been limited.

The Commission is eager to encourage the States' use of Section 6d and, in addition, to involve them more extensively in actions against those who offer fraudulent off-exchange investments in commodities such as diamonds, coal and strategic metals. We are proposing two statutory amendments designed to achieve these aims.

First, the Commission is requesting authorization to share with State and foreign government officials important information now subject to the confidentiality provisions of Section 8 of the Act. Under this proposal, Section 8(e) of the Act would be amended to permit the Commission to provide these officials with any information in its possession so long as it was satisfied that the information would only be used for bona fide law enforcement purposes (Section 17(c)(2) of the Bill). [*] The availability of this information will aid States in preparing their own cases. It will also enable them to assess whether to join litigation being prepared by the Commission. And, by making information sharing a two-way street, we believe it will improve cooperation between the Commission and the States.

There are also occasions when American citizens can be better protected if foreign law enforcement agencies have access to CFTC information. Charlatans operating from foreign bases, such as in Canada or Europe, or who move off-shore to island havens, may find their local governments more hostile if the evidence against them is shared by the CFTC with those governments.

Second, the Commission proposes to declare "open season" on off-exchange commodity frauds by specifically authorizing all Federal, State and local officials to prosecute these frauds under any relevant law or regulation. This would be accomplished by adding a new Section 12(e) to the Act which explicitly permits the application of other Federal and State laws to activities and persons who unlawfully engage in commodity transactions outside the Act's regulatory structure (Section 20(b) of the Bill). Under this "open season" provision, State Attorneys General or securities administrators, for example, would be authorized to take action either in court or administratively against persons selling certain off-exchange commodity investments (e.g., in diamonds, coal or strategic metals), and against any person engaged in an activity requiring registration or designation by the Commission who has not complied with those requirements. Activities which are subject to the comprehensive regulatory powers of the Commission, including exchange-traded futures, authorized commodity options programs and regulated leverage contracts, however, would remain within the Commission's exclusive jurisdiction.

---

[*] All citations to sections of the Bill are to the provisions of S. 2109.

The Commission's proposal is not intended to alter the current exclusive jurisdiction of the Commission vis-a-vis the States with respect to the regulation of registered firms, such as registered commodity pool operators. Part 4 of the Commission's present regulations [17 C.F.R. Part 4] contains a uniform, comprehensive, nationwide scheme of regulation for registered commodity pool operators. The Commission continues to endorse the Congressional judgment that a single, uniform program in this area is preferable to applying fifty different and sometimes conflicting schemes of State regulation.

Internationalization of the Futures Markets. The increasing internationalization of the futures markets poses a variety of regulatory problems for the Commission. On the one hand, the Commission is faced with the practical difficulties of obtaining information from and enforcing its rules as they apply to the large numbers of foreign participants in United States futures markets. On the other hand, the Commission is responsible for protecting United States citizens from fraudulent activities and other abuses relating to the domestic sale of foreign futures contracts.

The Commission believes it already has adequate statutory authority to achieve regulatory parity between foreign and domestic participants in the United States futures markets. Therefore, we are seeking no new legislative powers in this regard. And, while the Commission also has exclusive jurisdiction over foreign futures being sold in the United States, we believe some additional Congressional attention to this area is now warranted. 1/

A number of futures markets exist abroad and others are now under development. The Commission believes that the protection of American residents solicited to trade on these foreign markets may necessitate regulation of those who vend foreign futures from domestic locations. It may prove desirable, for instance, to require such vendors to comply with some of the regulatory requirements now imposed on futures commission merchants marketing domestic futures. To reaffirm our broad existing authority to prevent fraud in the domestic offer and sale of all futures contracts, 2/ the Commission

---

1/ Current Section 2(a)(1) of the Act grants the Commission exclusive jurisdiction over agreements and transactions involving contracts of sale of a commodity for future delivery traded or executed on any board of trade, exchange or market, regardless of whether such entity has been designated as a contract market under Section 5 of the Act.

2/ See, e.g., 17 C.F.R. §30.02, the Commission's rule prohibiting fraud in the sale of foreign futures contracts.

has proposed that a new Section 4(b) be added to the Act, which expressly authorizes us to develop, if needed, a regulatory system for those who market foreign futures from a domestic location (Section 3(b) of the Bill).

Enforcement of the Act.

In periods of fiscal austerity, a strong enforcement program can provide a comparatively cheap and more effective alternative to the adoption of costly new layers of regulation. Vigorous law enforcement protects the public by focusing on the unscrupulous few who violate the law. As a result, the costs of regulation are reduced for the majority of honest, law-abiding businessmen. In addition to seeking to enlarge further the role of the States in preventing and prosecuting off-exchange commodity fraud, the Commission has begun to sharpen its own enforcement tools. As part of that program, it is seeking a number of legislative changes.

"Aiding and abetting" is a well established basis for holding a person responsible for another person's violations. Those who intentionally assist another in violating the Act should not be able to escape responsibility simply because another person carried out the offense. In its present form, Section 13(a) of the Act provides that aiders and abettors may be held liable as principals only in administrative proceedings under the Act. Although Federal courts have generally recognized the applicability of common law principles of aiding and abetting to persons who assist others in violating the Act, this has not uniformly been so. In order to assure the consistent treatment of aiders and abettors both in administrative proceedings and before the courts, the Commission has proposed to expand Section 13(a) to apply to all proceedings under the Act (Section 21(a) of the Bill).

Violations of the Act are committed by people, not by abstract legal entities. As the Act is currently written, entities are generally liable for the acts of their employees and agents. The converse is not always true, however, with respect to those who control those entities and it is sometimes difficult for the Commission to reach behind corporate or partnership entities to obtain sanctions against specific individuals who instigate violations of the Act. To remedy this problem, the Commission has proposed the addition of a new Section 13(b) to the Act which would make clear that a person who directly or indirectly controls another person (or entity) which violates the Act, would himself be liable as a principal unless he did not know, or in the exercise of reasonable care, did not have reason to know of the facts constituting the violation (Section 21(c) of the Bill). Among other things, this provision would strengthen the Commission's ability to impose sanctions against individuals who are, in essence, the alter egos of corporations which have duties under the Act.

In its present form, Section 6c of the Act prevents the Commission from obtaining injunctions on an ex parte basis (i.e., without prior notice to the other party). The Commission is concerned that in some situations, prior notification will result in the destruction of books and records and the dissipation of customer funds. Actual experience validates this concern. To prevent destruction of evidence and conversion of assets, the Commission has proposed that Section 6c be amended to permit it to obtain ex parte orders from courts of competent jurisdiction, which prohibit destruction, alteration or disposition of books and records or the refusal to permit inspection thereof and which prohibit the transfer or removal of funds (Section 16 of the Bill). Ex parte orders would only be permitted for these limited purposes.

Under existing law, it is a felony for any futures commission merchant to embezzle or steal customer assets. The Commission is proposing to expand Section 9(a) of the Act so that similar conduct by any person registered or required to be registered under the Act is likewise a felony (Section 19(a) of the Bill). For example, commodity pool operators are entrusted with substantial sums of investors' funds, sometimes in the millions of dollars.

Access to Justice.

Reparations. Section 22 of the Commission's proposed bill would amend Section 14 of the Act to correct specific problems which the Commission has encountered in administering its reparations program, as well as to increase access to other forums for claimants seeking relief for violations of the Act. This proposal should increase the credibility of the noble experiment contemplated by the reparations program which is currently being undermined by the assessment of uncollectible awards and by extensive delays.

In 1978, the Commission sought certain changes in the Act which were designed to enlarge the class of persons subject to the Commission's reparations procedures to include unregistered persons. Over the course of the past four years, the Commission has encountered several obstacles, not anticipated at the time its legislative changes were recommended, to asserting jurisdiction over so-called "outlaw" firms or individuals in reparations. For example, claims must now be heard by the Commission even though the Commission has had no prior knowledge of the existence of the accused unregistered firm or individual and no opportunity to regulate or monitor its business practices. Additionally, unregistered firms and individuals often file in bankruptcy, are destitute, or have disappeared by the time a claim is asserted, resulting in uncollectible reparations awards. In these circumstances, the reparations process actually operates as a disservice to those who have already been harmed, by apparently promising recovery, which as a practical matter cannot be had. Moreover, these types of claims have served to delay the entire reparations process, thereby deferring the completion of cases where recovery is possible. For example, the number of reparations cases reviewed by the Commission increased from 873 in fiscal year 1978 to 1471 in fiscal year 1981. Accordingly, the Commission, in a reversal of its former position, is now seeking to eliminate reparations claims against individuals or firms not registered with the Commission (Section 22(c)(1) of the Bill).

The Commission is also seeking other modifications where statutory detail may inhibit prompt recoveries. For example, the Act currently provides that in reparations cases where the damages claimed do not exceed $5,000, a hearing is not required. This limit was raised from $2,500 to $5,000 in 1978 to increase the number of cases which could be resolved on the submission of papers alone. In order to increase its flexibility in developing procedures for the efficient settlement of claims, the Commission is proposing to eliminate this monetary restriction (Sections 22(a) and 22(c)(3) of the Bill). Under this proposal, the Commission would be able to have cases decided on documentary evidence without regard to the amount of damages claimed.

Also, since the reparations program seeks to pass upon the whole controversy surrounding each claim, including counterclaims arising out of the same set of facts, the Commission Bill would create appropriate sanctions against a claimant who has failed to honor a reparations award in favor of the counterclaimant. Trading privileges would be denied in such circumstances to the dishonoring party until payment is made. This new procedure is designed to insure the integrity of the reparations program and of the Commission's orders and to make the system more equitable for all participants (Section 22(c)(5) of the Bill).

Finally, the Commission's proposal would delete several of the complex procedural requirements created by the present statute which the Commission has found to be unduly cumbersome. Under its proposal, the Commission would not be required to ensure that its procedures conform to those that might ordinarily be required for more typical forms of agency action by the Administrative Procedure Act. This change should enable the Commission to fashion a program through rulemaking that will not promise more than it can deliver but will operate using efficient and fair procedures (Section 22(c)(3) of the Bill).

Arbitration. The Commission's proposed amendments to Sections 5a(11) and 17(b)(10) of the Act would enhance the use of arbitration as an attractive alternative to reparations (Sections 14(b) and 24(a) of the Bill, respectively). In particular, the Commission believes that if these sections are amended to eliminate the $15,000 limitation upon disputes which must be heard by exchanges and registered futures associations, customers with more sizeable claims would be encouraged to arbitrate their claims instead of petitioning for reparations hearings. As Sections 5a(11) and 17(b)(10) currently read, exchanges and registered futures associations may refuse to arbitrate a customer's claim against one of their members or employees if the amount in question exceeds $15,000. The Commission sees no reason why exchange or other private arbitration procedures for claims under $15,000 cannot provide equally viable forums for resolving customer claims in excess of $15,000 and believes there is no logical reason why reparations should be the only out-of-court forum for resolution of these disputes.

In this regard, I would note that the Commission already has taken other steps within the confines of the existing Act to encourage the use of exchange and other private arbitration facilities. In November, the Commission proposed amendments to its current arbitration and reparations regulations. These amendments to Part 180 are designed to encourage the arbitration of claims and to provide greater protections to customers who choose to use arbitration as a means of dispute resolution. By enhancing the public perception of arbitration as a fair, cost-effective and timely mechanism for resolving commodities claims, the Commission hopes to encourage greater use of arbitration procedures.

As a final note, the Commission's proposed amendment to Sections 5a(11) and 17(b)(10) would delete the present language in the Act requiring that the arbitration procedures shall not result in any compulsory payment except as agreed upon by the parties. This proposal is intended to make clear that awards rendered on counter-claims in arbitration are binding without the necessity of an agreement. The Commission's proposal does not affect the existing requirement that the use of the procedure by the customer is voluntary or the Commission's understanding that, under this provision, exchange members must participate in arbitration proceedings which the customer has elected to pursue.

Speculative Limits.

Consistent with its recent rulemaking requiring contract markets to adopt speculative position limits for the futures contracts they trade, the Commission's proposal would confirm the authority of exchanges to set these limits, as well as limits on the number of speculative positions a person may hold in commodity options (Section 4(e) of the Bill). The proposal would also expressly confirm the Commisson's authority to set speculative limits in futures contracts through rulemaking and provide that limits set by the exchanges could not differ from those set by the Commission without the Commission's approval.

The Commission believes that exchange limits are one of the most useful tools to ensure orderly trading and to prevent market excesses. To underscore this, the Commission has also proposed that the violation of speculative limits set by the exchanges would be a violation of the Act as if they had been set by the Commission. This proposal should lend credibility to the exchanges' efforts and demonstrate the Commission's commitment to ensure that the markets operate fairly so as better to achieve the important economic purposes they are designed to serve.

Registration.

As I have previously noted, this legislative proposal reflects the Commission's firm intention to promote the evolution of self-regulation in the commodity industry and to assure responsibility by registrants for their employees and associates. Consistent with this objective, the Commission is proposing to revamp the existing registration procedures in three important respects in order to lay the foundation for the Commission to move to an oversight role in this area. The new registration provisions advocated in this proposal would also expand the responsibility of registrants for the conduct of their principals and key employees. These responsibilities are consistent with prudent business practices and as such should not create unwarranted burdens.

Parity of Registration Requirements. First, in conformity with the Congressional intent expressed at the time of the Commission's creation, our proposals would extend existing registration requirements to include all persons who handle customers' funds or who influence or advise customers as to the investment of those funds (Section 8a(1) of the Act and Sections 18(b)(1)-(4) of the Bill). [3/] Specifically, the proposals require the partners, officers, employees and agents of commodity pool operators who solicit pool participations or who supervise such persons to register as associated persons of commodity pool operators (Section 4k(2) of the Act and Section 9(c) of the Bill). Similarly, personnel of commodity trading advisors who solicit discretionary accounts or who supervise such persons would also be required to so register (Section 4k(3) of the Act and Section 9(e) of the Bill).

The Commission believes that the registration of associated persons of commodity pool operators and commodity trading advisors is necessary to ensure that such persons are qualified to offer pool participations and investment advice to potential participants and clients and are adequately supervised. Requiring registration will permit the Commission to conduct fitness checks through the FBI, SEC and other sources to uncover past misconduct such as criminal convictions, to proceed more effectively against individuals associated with registered entities who violate the Act, and to subject these persons to reparations claims. The need to screen these categories of commodity professionals has become more urgent because of a dramatic increase in the number of commodity pool operators and commodity trading advisors, and a concomitant increase in the number of customers and the amount of funds under management by them. For example, the number of

---

[3/] H.R. Rep. No. 93-963, 93d Cong., 2d Sess. 37 (1974).

commodity pool operators registered with the Commission rose from 494 at the end of fiscal year 1978 to 882 at the end of fiscal year 1981, an increase of more than 75%. (Because such individuals have not previously been actively regulated by the Commission, however, there are no figures available as to the number of persons who/would be affected by a registration requirement for persons who solicit customers on behalf of such operators and advisors.) This change would make our registration program more consistent because it would require all persons who are essentially functioning in the same capacity as persons associated with futures commission merchants to register as associated persons.

In this connection, the Commission has already proposed a rule which would require any person who solicits customers on behalf of a commodity trading advisor or commodity pool operator or who supervises such persons to register as a commodity trading advisor. 47 Fed. Reg. 2325 (January 15, 1982). The Commission believes, however, that it is more appropriate to register such persons as associated persons because their activities so closely parallel those performed by persons now in that category. In addition, by so designating them, the Commission may more readily make their employers responsible in the first instance for the supervision of sales practices and fitness. This proposal also will facilitate the Commission's response to public inquiries about such persons by avoiding the creation of two classes of commodity trading advisors who do essentially different things. Finally, the use of the commodity trading advisor category in the Commission's proposed rule was intended to assure antifraud coverage under the statute. Our proposal clarifies that those antifraud provisions of the Act which apply to commodity pool operators and commodity trading advisors would also apply to their associated persons (Section 4o of the Act and Section 12 of the Bill).

The Commission's proposals also would resolve any existing uncertainty as to the status of agents of futures commission merchants. Although most futures commission merchants conduct their sales efforts through a network of wholly-owned branch offices staffed by personnel who are registered as associated persons and for which they already assume full responsibility, a relatively small proportion of futures commission merchants rely upon "agents" as selling arms of the firm. It is estimated that ten percent of the futures commission merchants registered with the Commission employ eighty percent of the agents used in this manner. Agents generally are separately owned and run under contract with the futures commission merchant. Futures commission merchants frequently disavow any responsibility for sales abuses or other violations committed by these agents. The Commission considered various ways to protect the public under these circumstances. One approach, to create a new and separate registration category for "agents" (e.g., as "fully disclosed brokers"), was considered. However, many of these "agents" are individuals or very small businesses, and a separate regulatory structure could prove to be too costly and burdensome for them. The Commission proposes instead to create parity between those futures commission merchants using a branch office system and those using "agents" by requiring the latter to register with the Commission under the existing registration category of "associated persons" (Section 4k(1) of the Act and Section 9(a) of the Bill). Thus, the futures commission merchant would be responsible for its agents to the same extent as for its branch offices. It should be noted that this proposal is entirely consistent with the existing provision of the Act which makes a principal liable for the acts and omissions of its agents. 4/

Our registration proposals also would extend the Commission's authority to establish a proficiency examination requirement (as well as other fitness qualifications) to all persons who are required to register with the Commission (Section 4p of the Act and Section 13 of the Bill). Under existing law, the Commission's authority in this respect applies solely to futures commission merchants, floor brokers and those persons associated with them. Pursuant to that authority, the Commission has proposed a rule which generally would require new applicants, as a condition of registration as associated persons, to pass a specified written proficiency examination within two years preceding the filing of their registration application. 5/ In proposing this rule, the Commission was aware that several commodity exchanges (Chicago Board of Trade, Chicago Mercantile Exchange, Minneapolis Grain Exchange and New York Futures Exchange, Inc.) already have such a

---

4/ Section 2(a)(1) of the Act, 7 U.S.C. §2 (Supp. IV 1980).

5/ 46 Fed. Reg. 20679 (April 7, 1981).

requirement in place, that is, they require associated persons of their members to pass the National Commodity Futures Examination. [6] It is envisioned that any testing program permitted by statute or required by rule will be developed and administered by a registered futures association. The recent registration of the National Futures Association makes this development more likely to occur in the near future. Our testing proposal would further effectuate Congress' objective that all commodity professionals who deal with the public meet certain standards. [7]

Streamlining Registration Procedures. Second, the Commission's proposals streamline and simplify the current registration procedures to enable the Commission to register fit persons more expeditiously and to remove unfit persons from the industry more promptly. The proposals would amend the Act to establish a system of "statutory disqualifications" which would enumerate the most important bases for finding applicants or registrants unfit for registration (Sections 8a(2), (3) and (4) of the Act and Sections 18(c), (d) and (e) of the Bill, respectively). This will mean that Commission staff need no longer bear the burden of proving what conditions warrant a Commission finding of unfitness, and should therefore reduce the amount of time and resources which the staff as well as applicants and registrants currently devote to preparing and litigating registration cases. In addition, such a system would provide advance notice to applicants and registrants of the most significant fitness standards used by the Commission, thereby promoting fairness and uniformity of treatment.

The registration disqualification amendments create a two-tiered system under which the Commission may deny, condition, suspend, or place restrictions upon registration without a prior hearing or revoke registration after such a hearing as may be appropriate in cases which involve especially grave offenses that are clearly related to a person's fitness for registration with the Commission. These statutory disqualifications are in general the following:

(A) a currently effective suspension or revocation of registration;

(B) a refusal of registration by the Commission after a hearing within the preceding five years;

---

[6] Id. at 20680.

[7] H.R. Rep. No. 93-963, 93d Cong., 2d Sess. 37 (1974).

(C) a permanent or temporary court order (which is still in effect), including a court order entered pursuant to an agreement of settlement, which enjoins acting as a Commission registrant or a securities professional, or engaging in activities which involve commodity interests or securities;

(D) a felony conviction within the preceding ten years which involves commodity interests or securities, or the conduct of a commodities or securities business, or which involves certain enumerated offenses of particular gravity, e.g., bribery, misappropriation of funds, securities, or property, bankruptcy fraud, racketeering or theft;

(E) findings made by a court or an appropriate governmental body. including those contained in agreements of settlement, of a violation of the Act, the Federal securities laws, or similar statutes within the preceding ten years;

(F) an outstanding Commission order imposing certain sanctions, e.g., denial of trading privileges on any contract market;

(G) a willful material misstatement or omission in the registration application as to whether the applicant is subject to any of the foregoing statutory disqualifications; or

(H) the existence of a principal or vesting of control in a person who is subject to a statutory disqualification.[8/]

Each disqualification is based upon a previous finding or order by the Commission, a court, or another governmental body. As a result, whether or not a person is subject to such a disqualification generally is readily ascertainable by checking officially maintained governmental records. The Commission has concluded, as Congress previously concluded by enacting Sections 4n(5) and 8a(2)(A) of the Act, that in some cases there is no need to provide a hearing before the Commission to keep an unfit person out of the commodities business. By eliminating the need to provide hearings to persons who are manifestly unfit for registration, the Commission will be able to dispose of most registration cases quickly, thus freeing resources for the performance of its other important regulatory and oversight functions.

8/ These conditions are modeled after existing provisions of the Act, Commission regulation 1.10e, 17 C.F.R. §1.10e (1981), the Commission's interpretative statement regarding good cause for denial of registration, 17 C.F.R. Part 1 Appendix A, and certain analagous provisions of the Securities Exchange Act of 1934.

Offenses which are less grave, or which require factfinding or for which it may be appropriate for the Commission to consider mitigating or extenuating circumstances or evidence of rehabilitation (e.g., a misdemeanor conviction), would be grounds for a finding of unfitness only after an opportunity for hearing before the Commission (Section 8a(3) of the Act and Section 18(d) of the Bill). In keeping with the Commission's desire to allocate responsibility for its employees, these proposals also require that reasonable inquiry be made by employers who are registered into the background of such persons. If a reasonable effort is made to discharge these obligations, however, the registrant's registration will not be at risk (Sections 8a(3) and 4k(5) of the Act and Sections 18(d) and 9(g) of the Bill, respectively).

The Commission recognizes that for obvious reasons, the making of full fitness checks is likely to be time-consuming. Therefore, the proposals authorize the Commission to grant a six-month provisional license to applicants (Section 8a(1) of the Act and Section 18(b)(6) of the Bill). This procedure will permit an apparently qualified applicant to begin work or to conduct business prior to completion of the registration review.

In this vein, the proposals would provide the Commission with additional flexibility in the administration of the registration requirements by authorizing the Commission to grant registration on a conditional basis (Sections 8a(2) and (3) of the Act, and Sections 18(c) and (d) of the Bill, respectively), and to register associated persons either permanently or for a substantial length of time (Section 4k(4) of the Act and Section 9(f) of the Bill). At present, the Commission must either grant or deny registration. The discretion to grant conditional registration will allow the Commission to permit an applicant to conduct business, under certain stipulations, in circumstances where neither approval nor denial would be appropriate and where, at present, denial might be the only available option. For example, the Commission could condition registration on the creation of additional supervision requirements. [9] So conditioning registration puts real teeth into those requirements, inasmuch as the registration of such person would be at risk if it failed to comply.

---

[9] Current Section 8a(2) of the Act does not expressly permit the placing of conditions upon registration.

The proposals also eliminate the current burden of annual registration of associated persons by authorizing the Commission to prescribe the effective period of the registration of associated persons of futures commission merchants, commodity pool operators and commodity trading advisors. Similarly, it is intended that the proposals permit the Commission to require that an applicant for registration as an associated person of any category of registrant be "sponsored" by the registrant who will employ him, consistent with the Commission's recently revised registration rules. [10]

In connection with reducing the burdens associated with the current registration scheme, the Commission also has recommended several revisions in the existing definition of the term "commodity trading advisor" which is contained in Section 2(a)(1) of the Act (Section 2(a)(3) of the Bill). The current definition includes persons who give advice concerning the value of commodities or who issue analyses or reports concerning commodities for compensation or profit and as part of a regular business. As such, this definition literally encompasses thousands of persons (e.g., consumer advisers, jewelry appraisers, economists who recommend the purchase of gold as a hedge against inflation) who have no connection with futures, options, or leverage transactions. [11] The proposal would narrow the definition to exclude under most circumstances those who merely advise as to cash commodities or their value. The Commission, however, retains the authority to issue regulations which include within the new definition any person who gives such advice if that will effectuate the purposes of this provision and the Act. [12]

The proposals also extend the current exclusions from the commodity trading advisor definition to the electronic media (e.g., television reporters and commentators) and a new exclusion is added for trustees of certain pension plans which are subject to extensive regulation under the Employee

---

[10] 45 Fed. Reg. 80485 (December 5, 1980). The effective date of these rules has been deferred to July 1, 1982. 46 Fed. Reg. 24940 (May 4, 1981),

[11] Cf. Section 3 of the Act, 7 U.S.C. §5 (1976).

[12] By regulation, the Commission has exempted certain persons who conduct cash market businesses from having to register as commodity trading advisors if their trading advice is solely incidental to the conduct of these businesses. Such persons remain subject to the antifraud and reparations provisions of the Act. Commission regulation 4.14(a)(1), 46 Fed. Reg. 26004, 26015 (May 8, 1981).

Retirement Income Security Act of 1974, provided that the furnishing of trading advice is solely incidental to the discharge of their fiduciary responsibilities. This exclusion is particularly significant in view of the increasing interest in and use of futures trading by pension plan managers to hedge their portfolios against interest rate fluctuations.

Framework for Delegation of the Registration Function. Third, the proposals provide for the performance by any person of any portion of the Commission's registration functions, in accordance with rules approved by the Commission and subject to the Act (Section 8a(10) of the Act and Section 18(h) of the Bill). In addition, they provide the Commission with authority to require any registered futures association to undertake this responsibility with respect to each of its members other than a contract market and each associated person of such members (Section 17(o) of the Act and Section 24(d) of the Bill). These proposals together would enable the Commission to delegate the processing of registration applications to the National Futures Association. It is in this context that the system of statutory disqualifications and other amendments proposed by the Commission must be viewed. These new provisions, by creating a virtually self-executing system with clear guidelines as to the most important grounds of unfitness, make such a delegation more feasible. Of course, it is contemplated that the discharge of such delegated responsibility will be subject to Commission oversight, with any decision regarding registration by a futures association appealable to the Commission. Moreover, this proposal is not intended to alter the fact that registrants are deemed to be registered with the Commission. If these proposals are implemented, the Commission will be able to concentrate its efforts and its resources on performing those functions, including enforcement functions, which require its special expertise rather than on completing "paperwork."

Contract Market Rules.

In 1974 and as strengthened in 1978, Congress gave the Commission an affirmative oversight role in the area of exchange rulemaking. Currently, no exchange rule or rule change relating to contract terms or trading requirements may be implemented before the Commission has approved it, unless it is purely operational or administrative in nature. Having now had several years' experience, and despite strides in improving the internal processing of rule submissions, the Commission believes that modifications in this review process may be made in order to streamline this process without jeopardizing the essential oversight role which Congress intended the Commission to play (Section 5a(12) of the Act and Section 14(c) of the Bill).

As proposed by the Commission, only those exchange rules that either are "of major economic significance" or relate to the terms or conditions of a contract would remain automatically subject to a statutory prior approval requirement. Rules relating to the setting of levels of margin will continue to be excluded from the entire process, and the exchanges' right to take emergency actions would not be impeded. All other rule proposals could be implemented by an exchange after 10 days' notice to the Commission, without prior approval, unless the Commission determines within that time period that the proposed rule merits formal review and approval, or unless the exchange itself requests such action. The Commission is also recommending comparable rule review and approval simplification for rules of registered futures associations (i.e., the National Futures Association) (Section 17(j) of the Act and Section 24(c) of the Bill).

As a result, the exchanges and the NFA will have the opportunity to place the vast majority of their rule proposals into effect without any in the past, the Commission retains the right to review any rule (except margin levels) after it is implemented and to disapprove it under the standards in the Act.

In addition, the Commission has found publishing the full texts of economically significant rule proposals as required at present to be very expensive. As a result, the Commission is recommending that a short, descriptive notice be published in lieu of the full text. Such a notice not only will minimize the substantial expense involved, but also should result in prompter publication — and thereby prompter processing — of the proposals.

The need for prior review and approval of certain important exchange rules, which Congress recognized when it enacted the requirement in 1974, has not diminished over the years. With this in mind, the Commission strongly believes that the procedural changes it is proposing will expedite the entire rule review process without undermining the purposes of the Commission's review role as Congress originally intended.

Concomitant with this streamlining of the Commission's role in the rule approval process, the Commission recommends that Section 5a(8) of the Act be amended to assure that the exchanges enforce their rules (Section 14(a) of the Bill), regardless of whether the rule was approved by the Commission prior to its implementation, had become effective under the proposed amendments to Section 5a(12) or is required to be enforced by Commission regulation.

Leverage Transactions.

The offer and sale of leverage contracts are recognized in the Act, even though leverage transactions are conducted directly between a leverage firm and its customer on an off-exchange basis. Since being vested with jurisdiction over gold and silver leverage transactions in 1974 (and with jurisdiction over leverage transactions involving other commodities in 1978), the Commission has studied and monitored the offer and sale of leverage contracts in the United States.

Congress has banned leverage transactions in those commodities regulated under the Act prior to 1974. Although the Commission has endeavored to categorize and to determine how best to treat leverage transactions in other commodities (including convening an Advisory Committee in 1975 and conducting an empirical survey of the industry in 1978), the Commission has not yet resolved this question to its satisfaction.

Thus, in regulating this area, the Commission has taken only two initiatives: (1) the adoption of a general anti-fraud rule; and (2) the imposition of moratoria precluding the expansion of this business while the Commission gains experience with these vehicles and determines their appropriate treatment. 13/

Therefore, the Commission has proposed an amendment to the Act (Section 25 of the Bill) which would (i) ratify and extend for a two-year period the existing moratoria which the Commission has established on the entry of new firms into the leverage business and on the introduction of new leverage contracts, 14/ and (ii) direct the Commission to study leverage

---

13/ 17 C.F.R. Part 31 (1981).

14/ One moratorium governs leverage transactions involving gold and silver, and the other governs leverage transactions involving all other commodities.

transactions during that two-year period and to submit the results of that study to the Commission's Congressional oversight committees. This will ensure a fixed "universe" of leverage firms and leverage contracts for study, and will avoid the hardship and unfairness which could result if new business ventures were permitted during the study only to be banned or otherwise adversely affected by its results. The Commission proposes that its study include recommendations as to how and by whom leverage transactions should be regulated. In this connection, Section 25 of the Bill directs the Commission to examine whether there is a national public interest to be served by leverage transactions requiring that they be Federally regulated; whether the national public interest overrides any State interest in their regulation; whether leverage transactions should be prohibited; whether any such transaction is a contract for future delivery within the meaning of the Act; and whether an appropriate regulatory scheme should be adopted permanently to govern such transactions if the Commission determines they are not contracts for future delivery within the meaning of the Act. The study would also include any proposals for additional legislation that the Commission believes is necessary.

A majority of the members of the Commission is not yet sufficiently conversant with leverage transactions to offer a definitive proposal to the Congress at this time. The moratorium and the study that we propose will assure that hasty and unwise actions are not taken.

User Fees.

For more than thirty years, Congress has expressed the intention that, to the extent possible, the agencies of the Federal government should be self-sustaining. Indeed, the Independent Offices Appropriations Act of 1952 ("IOAA") (31 U.S.C. §483a) provides that:

> It is the sense of the Congress that any work, service, publication, report, document, benefit, privilege, authority, use, franchise, license, permit, certificate, registration, or similar thing of value or utility performed, furnished, provided, granted, prepared, or issued by any Federal agency . . . to or for any person . . . shall be self-sustaining to the full extent possible, and the head of each Federal agency is authorized by regulation . . . to prescribe therefor such fee, charge, or price, if any, as he shall determine . . . to be fair and equitable taking into consideration direct and indirect cost to the Government, value to the recipient, public

> policy or interest served, and other pertinent facts. . . .

Although the Commission collects fees pursuant to that authority and pursuant to supplementary authority contained in the Commodity Exchange Act,[15] the fees authorized by the IOAA are in general limited to the value to the recipient of the service giving rise to the fee.[16]

In amending the Act in 1978, however, Congress separately authorized the Commission to "develop and implement a plan to charge and collect reasonable fees to cover the estimated cost of regulating transactions under the jurisdiction of the Commission."[17] Accordingly, the Commission recently directed its staff to analyze the principal fees charged by the commodity and securities exchanges, the fees paid by the securities industry to the Securities and Exchange Commission, the anticipated sources of funding for the National Futures Association and separately, to review the relative merits of various types of user fees.

---

[15] For example, the Commission assesses a $25.00 filing fee for reparation proceedings under the authority contained in the IOAA. In addition, Section 8a(4) of the Act authorizes the Commission to establish "reasonable fees and charges" for registrations and renewals thereof. The Commission collected $20,875 in reparations fees and $1,002,919 in registration fees in fiscal year 1981.

[16] See National Cable Television Ass'n, Inc. v. United States, 415 U.S. 336 (1974); Federal Power Comm'n v. New England Power Co., 415 U.S. 345 (1974).

[17] Section 26 of the Futures Trading Act of 1978 (7 U.S.C. §16a) provides:

> Notwithstanding any other provision of law, the Commodity Futures Trading Commission may develop and implement a plan to charge and collect reasonable fees to cover the estimated cost of regulating transactions under the jurisdiction of the Commission. However, prior to implementing such a plan, the Commission shall report its intention to do so to the House Committee on Agriculture and the Senate Committee on Agriculture, Nutrition, and Forestry. The Commission shall include in its report the feasibility and desirability of collecting such fees. Any plan developed under this section shall not be implemented until approved by the House Committee on Agriculture and the Senate Committee on Agriculture, Nutrition, and Forestry. Fees collected under any plan approved under this section shall be deposited in the Treasury of the United States as miscellaneous receipts.

Recent decisions by United States Courts of Appeals concerning the constitutionality of legislative vetoes raise questions whether the provision in Section 26 requiring Congressional committee approval of a fee plan developed by the Commission pursuant to Section 26 renders that Section unconstitutional. See Consumer Energy Council of America v. Federal Energy Regulatory Commission, Nos. 80-2184 and 80-2312 (D.C. Cir., filed Jan. 29, 1982). See also Chadha v. Immigration and Naturalization Service, 634 F.2d 408 (9th Cir. 1980), cert. granted, 102 S. Ct. 87 (1981).

The Commission's staff considered seven alternative methods of assessing a user fee before concluding that the Commission should recommend to Congress the enactment of legislation which would provide for transaction fees to be paid by users of the futures markets, with a distinction being made between members and non-members of self-regulatory organizations (the contract markets or a registered futures association, such as the National Futures Association). That recommendation, which was adopted by the Commission and is the basis of the Commission's proposed user fee legislation (Section 26 of the Bill), also provides for separate fees to be paid by leverage transaction merchants and dealer option grantors.

I would like to highlight some of the principal features of the Commission's recommendation:

First, there would be a transaction fee, assessed upon each exchange, of 12 cents per side (i.e., long or short) on each futures contract and option made for the account or benefit of any person who is not a member of a registered futures association or of the exchange where the trade was made. In addition, the exchanges would be assessed a fee of 6 cents per side on each futures contract and option made for the account or benefit of any person who is a member of a registered futures association or of the exchange where the trade was made. The 6-cent differential recognizes that exchanges and futures associations already would be assessing fees on their members toward the costs of self-regulation. The fee would be payable on exchange-traded options contracts when they are granted, offset or exercised. The fees would be remitted annually to the United States Treasury.

Second, there would also be a fee of three dollars for each dealer option granted and each leverage contract entered into by a dealer option grantor or a leverage contract vendor. These fees would be remitted annually to the United States Treasury by the grantor or leverage contract vendor, respectively. The Commission is recommending that separate fees be assessed with respect to dealer option grantors and leverage contract vendors because the Commission has determined that the expenditure of Commission resources necessitated by the regulation of these entities would not be compensated for by those firms' payment of the transaction fee on futures and exchange-traded options since they would only be payable if a grantor or leverage vendor used the futures markets for hedging or speculative purposes.

Third, the Commission would be authorized to suspend the assessment of the statutory fees if the amounts collected exceed the Commission's current budget for the fiscal year. In addition, the Commission would be given the authority to reduce, suspend or waive any part of the fee, or its application to any person, upon a finding that the fee was causing significant adverse effects upon the operations of any market or person.

Finally, an Advisory Committee of affected market users would be created to consult with the Commission about the fee program and to prepare a report to Congress on that program no later than June 30, 1985.

Conclusion.

For 60 years, from the enactment of the Grain Futures Act of 1922 to the present, there has been a consistent Federal interest in the even-handed regulation of futures trading. That Act, which superseded the Futures Trading Act of 1921 (the earlier Act having been declared by the Supreme Court to be an unconstitutional exercise of the taxing power), established the foundation for what, in 1936, was to become the Commodity Exchange Act. The 1936 amendments extended the scope of federal regulation from grains to cotton and other specified agricultural commodities and conferred new and additional authority to prosecute market abuses and fraud by previously unregulated commodity brokers. During the ensuing years, the 1936 Act was intermittently amended to bring additional commodities within its scope. The Act was further amended in 1968 to augment existing law in an effort to ensure the financial stability of futures commission merchants by authorizing the establishment of minimum financial requirements, to increase the penalties for manipulation and other abusive practices, and to allow the issuance of administrative cease-and-desist orders.

By the early 1970s, however, it had become apparent that the futures markets were playing an increasingly important role in the nation's economy. By 1974, Congress was aware that "a regulatory agency cannot be expected to oversee the rapidly expanding and complex futures markets without additional tools with which to do the job and proper organization and funding."[18]

---

[18] S. Rep. No. 93-1131, 93d Cong., 2d Sess. 19 (1974).

Accordingly, when it created the Commission in 1974, Congress took steps which were deemed necessary at the time to ensure strong and consistent Federal regulation of the futures markets and of other aspects of commodity trading. Thus, Congress stipulated that in addition to greatly expanding the powers of the newly-created Commission relative to those of its predecessor agency, the Commodity Exchange Authority, the Commission would, with certain limited exceptions, have exclusive jurisdiction over all aspects of commodity futures and related transactions, both with respect to the States and with respect to other Federal agencies such as the Securities and Exchange Commission.

At the same time, recognizing that an industry-wide self-regulatory organization could beneficially complement the Commission's authority,[19/] Congress specifically authorized the Commission to register a futures association if it met the standards established in the 1974 legislation. By the time of the Commission's first reauthorization, however, no application for the registration of such an association had been filed with the Commission. Congress responded by amending Section 17 to facilitate and expedite the formation and operation of a "Title III organization."[20/]

Similarly, Congress recognized in 1978 that the preemption of the States' authority in the areas regulated by the Commission had inadvertently created a jurisdictional "shield" which was successfully being interposed by unregistered — and oftentimes unregulated — swindlers who asserted the Commission's exclusive jurisdiction as a defense to enforcement actions brought by State authorities. Congress accordingly enacted a new Section 6d of the Act, which expressly authorized State officials to bring suit in the Federal courts to enforce the provisions of the Act on behalf of their residents and to use local courts and local antifraud laws to attack commodity wrongdoing.

[19/] See, e.g., H.R. Rep. No. 93-975, 93d Cong., 2d Sess. 4 (1974).

[20/] See, e.g., 124 Cong. Rec. S10535 (daily ed. July 12, 1978) (remarks of Senator Leahy).

Further, during the reauthorization, despite an unwillingness to bifurcate the regulation of futures trading depending on whether or not the commodity underlying a futures contract was a "security," Congress nonetheless directed the Commission to solicit the views of other affected agencies (such as the Securities and Exchange Commission and the Department of the Treasury) when application is made for a futures contract on instruments under the jurisdiction of those agencies and to maintain communications with those agencies and with the Board of Governors of the Federal Reserve System.

The last four years have brought more dramatic changes in the industry. Thirty-eight new futures contracts -- ranging from gasoline and lumber to Treasury bills and Eurodollars -- have been designated since the Commission's last reauthorization. Trading volume has increased dramatically — from just over 54 million contracts in fiscal year 1977 to more than 100 million in fiscal year 1981. This surge in trading has been accompanied by the increasing use of the futures markets by financial institutions and businesses to shift price risks in a manner comparable to the more traditional use of those markets by farmers and others involved in the marketing of grain and other agricultural products. The general public has also become increasingly active in the futures markets -- not only as individual customers, but also through participation in professionally managed commodity pools and accounts. Not surprisingly, there has been a corresponding increase — to nearly 52,000 individuals and firms — in the number of persons registered with the Commission.

The Commission is, of course, cognizant of these changes in the industry. Its present legislative proposal is, therefore, designed to accommodate the ever-changing dynamics of the industry without creating undue and unnecessary obstacles to the industry's evolutionary growth. At the same time, the Commission is well aware of its statutory mandate -- expressed in more than sixty years of Federal legislation — to ensure fair and honest dealings in the Nation's futures markets.

The measures contained in the Commission's proposal are designed to foster greater self-regulation by the industry, to build upon the foundation which has been established under earlier Congressional enactments and to facilitate the transfer or restoration of certain functions and responsibilities which can appropriately be delegated to the industry, restored to the States, or allocated within the Federal government so as to eliminate overlapping and potentially duplicative regulation.

If the Subcommittee needs further information in connection with this statement or further elucidation of the Commission's proposal in order to complete its review of that proposal, or otherwise for the completion of the reauthorization process, the Commission and its staff are, of course, available for this purpose.

STATEMENT OF

LEO MELAMED

PRESIDENT, NATIONAL FUTURES ASSOCIATION

BEFORE
THE SUBCOMMITTEE ON AGRICULTURAL
RESEARCH AND GENERAL LEGISLATION
SENATE COMMITTEE ON AGRICULTURE,
NUTRITION AND FORESTRY

March 1, 1982

Mr. Chairman, Members of the Committee.

I am Leo Melamed, Chairman of Dellsher Investment Company; Special Counsel to, and a former Chairman of, the Chicago Mercantile Exchange; and -- since 1976 -- an organizing Director and President of the National Futures Association. I am delighted to appear before you today on behalf of NFA. Accompanying me are Patricia Carlile, NFA's Acting Executive Director; and John Stassen, a partner of Kirkland & Ellis, NFA's General Counsel.

I appear before you today to acquaint you with what may be the very short biological history of the life of an entity conceived by the very same body which all of you proudly represent. A life which is today in your hands and whose future depends on your decision. A life which represents the hope and promise for our industry. A life which you sponsored, we devised and the CFTC ordained. I speak of the very short life of the National Futures Association, the NFA.

Conception of the NFA occurred in 1974, when the United States Congress adopted the Commodity Futures Trading Commission Act and provided, under Title III thereof, for the birth of a new self-regulatory organization for the commodity futures industry.

Two years of incubation followed the act of conception. The first signs of fertility occurred in 1976 when a not-for-profit corporation, sponsored by leaders of our industry and called the National Futures Association, was registered under the corporate laws of the State of Delaware.

What followed was one of the most difficult periods of gestation ever recorded in private-sector embryology. It was a five-year pregnancy, painful and dangerous, during which the prognosis for healthy birth was often in doubt. There were many from within and without our industry who were against its conception from the beginning.

The antagonists from within argued that NFA would represent but one more body of regulation in a world already possessed of too many regulators; that this new organization could not and would not fairly represent all the diverse sectors of the industry; that it would be too costly to ourselves; that it would duplicate functions of the CFTC; and, yes, some cynically asked why we should regulate properly and forcibly in areas where the CFTC had failed.

The antagonists from without argued simply that NFA represented a ruse to divert authority from the CFTC and that no self-regulatory private-sector organization could be trusted to do a proper job.

The protagonists were also from within and without our industry. They claimed to be much more responsible and farsighted. They insisted that NFA could be the potential savior of the futures industry and of its Federal regulatory agency. NFA could, they fervently espoused, save the industry from unnecessary duplicative regulations; carry out regulatory functions in a more proficient manner; relieve the CFTC of some obligatory burdens so that it could better carry out its oversight mandate in areas where it had failed to so do expeditiously; and that it would prevent the onerous onslaught of those who proposed a user fee system to defray the cost of regulation.

Aside from these specifics, the protagonists argued with what amounted to religious fervor that NFA was consistent with the banner of self-regulation which the futures industry has so proudly hailed for over 100 years of its existence.

I am delighted to report that in the end the protagonists prevailed. In March of 1981, the NFA went into heavy labor by filing its application before the CFTC for designation as a futures association pursuant to Section 17 of the Commodity Exchange Act.

As delineated in the comprehensive application package filed with the CFTC, NFA was devised to do the following:

- To effectively police the futures industry itself, as well as those segments operating outside the system of exchange standards and surveillance.
- To achieve better cost control over regulatory expense by eliminating duplication and conflict between governmental and self-regulatory programs.
- To facilitate a reduction in the costs of federal regulation for the benefit of taxpayers in general and market users in particular.

The labor pains were extreme. A lengthy and exhaustive, as well as constructive, review process followed. All went well, however, and with no small measure of pride the CFTC, acting as midwife, announced the NFA birth on September 22, 1981. The National Futures Association was designated as an official "registered futures association." The baby was born.

At first our industry went into shock. It had been so long and arduous a process, which many never believed would culminate in birth, that we were not fully prepared for the event. But soon the realization of parenthood took place and with it preparations for the offspring's wellbeing began.

I am pleased to report that our progress has been swift and impressive. Since December 15th, when Pat Carlile was chosen as Acting Executive Director, substantial sums of money have been committed to the project. The core of a full-time professional staff was brought on board to develop programs and systems for membership qualification, member registration, FCM financial audits and NFA's professional standards compliance programs. National headquarters of NFA were opened at 120 South Riverside Plaza in Chicago. An advisory was mailed to all exchanges and 3,500 futures industry professionals apprising them of the next immediate stages of NFA formation and the expected timetable for membership. A plan was formulated to appoint the first 40-person Board of Directors of NFA, which would represent every segment of our industry. And the agenda was prepared for a full briefing to our industry at the Annual Futures Industry Convention later this week.

In short, we were well on the way to fulfilling our objectives and on target for meeting the goal of being a significant self-regulatory factor in our industry by October 1 of this year.

NFA proposes to enhance regulation by assuming the following obligations:

1. Comprehensive FCM audits;
2. Introducing broker oversight and ethical standards;
3. Pool operator and trading advisor oversight and ethical standards;
4. Sales practice reviews;
5. Options program oversight of FCM's and introducing brokers;
6. Registrations and fitness standards for industry professionals, including sales personnel;

7. Speedy, inexpensive, equitable customer claim procedures;

8. Enforcement of ethical rules on all industry professionals.

We propose an emphasis on self-regulation by the nation's 11 commodity exchanges through:

1. Streamlined exchange rule-approval procedures;

2. Streamlined market-designation procedures;

3. Giving exchanges front-line responsibility over speculative limits;

4. Avoidance of duplicative and redundant programs, including surveillance and enforcement efforts.

If implemented, NFA estimates that it will permit the CFTC to reduce its staff levels by at least one-third and result in a substantial reduction of its 1983 budget request.

But a large cloud now hangs over NFA. Suddenly its very life is threatened -- even before it can justify its existence; before it can produce any of the benefits it was so painfully programmed to carry out; before it is even one year old.

The NFA program -- in fact, NFA's very existence -- is threatened by the CFTC's recent decision (supported by the Office of Management and Budget) to propose a special regulatory tax on all futures market participants, including hedgers and market makers.

Mr. Chairman, Members of the Committee, I am here to plead for the life of NFA, and to impress upon you why the enactment of the CFTC tax is unnecessary, unwise, and incompatible with the premises on which NFA was created.

The CFTC's proposed tax would deprive NFA of its funding base, destroying the underlying reason for its creation (*i.e.*, to absorb some of the regulatory burdens in a cost efficient manner), and remove the single most effective incentive of a self-regulatory organizaton -- to prevent duplicative oppressive regulation. Our industry cannot rationally be expected to pay twice for the same regulatory process. It makes little sense for our industry to fund a self-regulatory organization if the CFTC plan is enacted.

CFTC Chairman Johnson is and has been for many years a foremost protagonist of NFA. I know because I worked with him on its behalf during the many years of gestation. But he is in error when he now says, as he recently did, "that proponents arguing abandonment of NFA if a fee system is adopted are largely the same people who earlier opposed NFA for other reasons."

Mr. Chairman, I represent one of the seven organizers of NFA who toiled against bitter odds to give birth to this entity, and I am here respectfully to advise you that we cannot in good conscience tell our industry members that NFA represents the same purpose, the same promise, the same productive result, if the CFTC tax system is imposed.

Justice John Marshall said: "The power to tax involves the power to destroy." That is clearly the central view of the present Administration. President Reagan has repeatedly spoken out against burdensome taxation and its destructive force on the private sector. Succinctly, he set the tone for the Administration by declaring in his State of the Union Address that his plan for recovery is "removing unnecessary regulation to spark productivity." Moreover, both Republicans and Democrats alike have gone on record against excessive regulation and to urge a system of self-regulation in its place wherever possible.

A futures transaction tax is not merely perverse in economic terms and a dangerous incentive for growth of federal economic regulation, it represents the antithesis of the agreed-to theme of both the Administration and Congress.

Ours is not an instance where an industry is shirking its responsibilities. Quite to the contrary, the futures industry is exemplifying the finest tradition of participation in the burden of government. We are prepared, willing and capable of sharing the regulatory burden and costs, estimated at 6 to 8 million dollars annually, if given a chance. We are not prepared to duplicate these costs, however.

We agree with CFTC Commissioner David Gartner:

> "This organization [NFA] will be totally funded by the industry to the tune of millions of dollars annually. And [NFA] will take over many of the functions performed by the Commission.
>
> Having mandated the NFA, I do not believe . . . that the Commission should place an additional burden on market user[s] by way of the transaction tax."

In a separate document of legislative recommendations, NFA has set forth many compelling reasons why a transaction tax is indefensible from the standpoint of economic policy, principles of regulatory reform, and legal/historical doctrines. This document also contains recommendations which relate directly to NFA's ability to act as a self-regulatory unit which will improve the level and efficiency of regulation at significant cost savings to the U.S. taxpayer.

I respectfully request that this document, and the accompanying complete text of a "Futures Trading Regulatory Improvements Act of 1982," be made a part of the record of these hearings, and be given your most serious consideration.

We submit that if NFA is allowed to function and if our recommendations are implemented, then there is no reasonable or proper fiscal rationale for the imposition of a special regulatory tax on futures transactions. Not only will a significant cost savings to the Federal Government be accomplished through NFA, not only will the government have advanced its cause in favor of deregulation and on behalf of self-regulation, it will have avoided the danger seen by Federal Reserve Chairman Volcker when he cautioned: "One danger from . . . the imposition of heavy costs [on organized futures markets] is that activity will shift to unregulated channels here and abroad. . . ."

To put it precisely, NFA is the self-regulatory, de-regulatory answer to increased CFTC budget demands in an era of diminishing federal resources. NFA is an answer which cuts taxpayer costs significantly but actually enhances the level and quality of customer protection. It is an answer which requires no new taxes.

Towards this end, NFA makes the following specific recommendations for Commodity Exchange Act improvements:

1. Provide that NFA can assume the burden of all registration-related functions under the Act, at no cost to the government.

2. Provide that NFA's uniform, national arbitration system can effectively supplant the CFTC reparations system, at no cost to the government.

3. Direct the CFTC to achieve regulatory efficiency and economy -- integrating its programs with private-sector programs; avoiding duplication and redundancy; and permitting a substantial reduction in its budget, or at least a major reallocation of its resources.

4. Repeal current CFTC "user fee" authority hastily adopted in 1978 and replace it with a constitutionally permissible service fee provision to defray CFTC expenses which directly benefit particular recipients (for example, subscription charges,

charges for CFTC reports, duplication fees).

5. Prohibit the imposition of futures trading transaction and related taxes on a state and local level, since such taxes, wherever imposed, are incompatible with the economic function of futures markets.

We respectfully urge that these recommendations be enacted into law. Detailed supporting analysis is contained in the "bluebook" which we have submitted to you.

A brief comment is in order with regard to the CFTC's legislative proposals which relate directly to NFA. With the exception of one technical, correcting amendment -- which is included in NFA's legislative recommendations -- we believe that the CFTC proposals are wholly unnecessary and are not acceptable substitutes for NFA's recommendations. In particular, NFA opposes the proposal that the Commission be empowered to order NFA to carry out certain functions relating to registration, as well as the CFTC's recommendation concerning agents. We strongly endorse the industry recommendation for direct regulation of introducing brokers. The NFA program already calls for this, and we believe the Commodity Exchange Act should as well.

In closing, I think we all should remember that the futures markets of the United States have long functioned in the interests of both producers and consumers of agricultural products. Before the CFTC, there were the markets. The transferring of marketplace risks through futures has contributed to America's enjoying a degree of price stability and abundance of food products unknown elsewhere. Indeed, our agricultural industry is the marvel and envy of the rest of the world.

In recent years, financial futures have been introduced in this country, to open to the business community those same or similar benefits available in agriculture. These benefits are not inconsiderable in a period such as we live in, which has witnessed double-digit inflation and extremely volatile movements in interest rates. Financial futures have fast become a valuable and indispensable asset to business and money managers in our financial community. Indeed, financial futures are modern-day examples of the validity of Victor Hugo's adage that "necessity is the mother of invention."

We should recall, too, that the futures exchanges of the United States are among the oldest continuously existing financial institutions of the western world. The youngest major exchange is more than fifty years old. The oldest dates back almost a century and a half. Few institutions in any field of commerce approach, much less equal, that record.

The longevity of our exchanges is directly a result of stern discipline imposed internally by the members themselves. Long before there was even a suggestion of governmental oversight for the exchanges, the members were making and enforcing stringent rules to protect and defend the integrity of the markets. Those rules have no parallel in other sectors of business. Few industries can boast as we can that no single dollar of the public's money was ever lost as a result of a failure or insolvency of an exchange member firm.

NFA is proud to become a part of this great tradition of self-discipline and self-regulation. NFA is willing and able to bear its share of the burdens, its share of the costs -- if just given a chance.

Finally, our economic system, our social system, our political system already are staggering under the excesses of those who trust government regulation and distrust freedom. Of late, however, there is a general recognition that this country and the Congress must move in the direction of lessening the burdens of regulation.

The CFTC's bill, including its tax plan, is a giant step in the opposite direction. I do not believe that the members of this Committee will want to add to the burdens already imposed upon our free and functioning futures markets by supporting such legislation. It is a measure that is ill-conceived and ill-considered; if enacted, it could only have the worst of ill effects.

NFA respectfully urges Congress to reject the CFTC's legislative and taxing plan and to choose the NFA alternative instead -- an alternative which is the only sensible and certain means to bring down the costs and burdens of federal regulation, while at the same time assuring that the public interest is well protected.

Thank you.

I will be happy to respond to any questions you might have.

(The following material was submitted by the National Futures Association.)

FUTURES TRADING REGULATORY IMPROVEMENTS ACT OF 1982

Short Explanation and Summary of Provisions

Short Explanation

The bill extends for six years[*] the authorization for appropriations for the Commodity Futures Trading Commission and makes several important changes in the Act establishing the Commission that are designed to modernize the Act and improve and make more efficient and cost-effective the regulation of the Nation's commodity futures and options markets.

Summary of Provisions

I. SHORT TITLE. The bill provides that, upon enactment, it may be cited as the "Futures Trading Regulatory Improvements Act of 1982".

II. MODERNIZATION OF LEGISLATIVE FINDINGS. The bill amends section 3 of the Commodity Exchange Act containing 1922 "legislative findings" to remove its anti-speculative bias and to restore the word "options."

III. POSITION LIMITS. The bill amends section 4a of the Commodity Exchange Act to eliminate its anti-speculative bias; to reallocate to contract markets the initial responsibility for establishing speculative limits; and to establish criteria (manipulations, corners, squeezes) and standards (volume and open interest) upon which the CFTC may, after a hearing on the record, order a contract market to amend its rules pretaining to limits.

---

[*] Under the terms of section 12(d) of the Commodity Exchange Act, as amended in 1978, authorization for appropriations for the Commodity Futures Trading Commission expires on September 30, 1982.

IV. CONDITIONS AND PROCEDURES FOR CONTRACT MARKET DESIGNATION. The bill amends section 6 of the Commodity Exchange Act to specify that the CFTC has six months either to approve new contract applications or to specify grounds for disapproval; and to specify that the affected exchange shall have ninety days thereafter to request a hearing on the record, which must commence within thirty days of such request. The bill amends section 5(g) of the Commodity Exchange Act by deleting the so-called "public interest test" and inserting instead a "hedging or risk-management test."

V. EXCHANGE RULE APPROVALS. The bill amends section 5a(12) of the Commodity Exchange Act to expressly provide that the term "rule" is limited to rules of general applicability, and does not encompass actions which implement or interpret rules. The bill further amends section 5a(12) of the Commodity Exchange Act to require the CFTC, in disapproving a rule, to specify the specific section or sections of the Act (including section 15) that the rule would violate; to provide that, if the CFTC has not instituted disapproval proceedings within sixty days after the filing of a proposed rule, or if instituted within sixty days such proceedings have not been completed within one hundred eighty days of institution, an exchange may put such rule into effect, subject to the provisions of section 5a(8) of the Commodity Exchange Act; and to eliminate certain publication requirements. The bill also amends section 5a(8) of the Commodity Exchange Act to codify CFTC Regulation 1.53.

VI. DISCLOSURE OF INFORMATION. The bill amends section 8 of the Commodity Exchange Act to exempt from disclosure under the Freedom of Information Act trade secrets, confidential and proprietary information, and information the Commission has undertaken to keep confidential; and to provide protections with regard to agency subpoenas similar to those contained in the Financial Privacy Act.

VII. EMERGENCY POWERS. The bill amends section 8a(9) of the Commodity Exchange Act to provide expressly for judicial review of both CFTC "emergency" determinations and the remedial actions prescribed.

VIII. INTRODUCING BROKERS. The bill amends various sections of the Commodity Exchange Act to provide for the direct regulation of "introducing brokers" and their employees.

IX. LIMITATION OF DOUBLE JEOPARDY. The bill amends section 6(b) of the Commodity Exchange Act to afford protection against successive penalties for the same conduct.

X. PERFORMANCE OF REGISTRATION FUNCTIONS BY A REGISTERED FUTURES ASSOCIATION. The bill amends section 8a of the Commodity Exchange Act to permit the CFTC to allow a registered futures association to assume all duties and expenses of registration under the Act and, with regard to futures commission merchants, introducing brokers, commodity pool operators, commodity trading advisors, and associated persons, to suspend redundant CFTC requirements altogether.

XI. RELATED TECHNICAL AMENDMENT. The bill repeals section 4k(3) of the Commodity Exchange Act, which relates to performance by a registered futures association of registration functions relating to associated persons.

XII. SUSPENSION OF THE REPARATIONS SYSTEM. The bill amends section 14 of the Commodity Exchange Act to permit the CFTC to suspend operation of its reparations system with regard to customer claims against futures commission merchants, introducing brokers, commodity pool operators, commodity trading advisors, and associated persons, as soon as registered futures association rules are in force providing for a uniform, national arbitration system.

XIII. REGISTERED FUTURES ASSOCIATION ARBITRATION. The bill amends section 17(b)(10) of the Commodity Exchange Act to delete the currently limited arbitration requirements for registered futures associations and replace them with a broad mandate that such associations provide a fair, equitable, inexpensive, and expeditious procedure through a uniform, national arbitration system for the settlement of disputes between members of the association directly doing business with the public and their customers regarding transactions regulated under the Act.

XIV. CONTRACT MARKET ARBITRATION. The bill amends section 5a(11) of the Commodity Exchange Act to provide that contract markets must provide procedures for the resolution of customer/member disputes only to the extent that such procedures are not available under the rules of a registered futures association.

XV. MANDATE FOR REGULATORY EFFICIENCY AND ECONOMY. The bill amends section 2 of the Commodity Exchange Act to direct the CFTC to effect economies in its operations and programs in light of self-regulatory operations and programs; to avoid regulatory duplication and redundancy between CFTC and private-sector programs; in general to further and promote self-regulation; and to limit CFTC functions to monitoring, review and oversight except as otherwise expressly provided in the Act. The bill further provides that the CFTC must file annual reports with Congress demonstrating its compliance with the directive; and that the directive does not create any rights, liabilities, or obligations upon which actions may be brought against the CFTC.

XVI. SERVICE FEES. The bill repeals section 26 of the Futures Trading Act of 1978 (prescribing procedures under which the CFTC might establish certain "user fees") and replaces it with a new provision in section 12 of the Commodity Exchange Act which broadly authorizes the CFTC to establish service fees which it determines to be fair and equitable taking into consideration the cost to the Government and the direct benefit and value to the recipient. All fees collected must be paid to the U.S. Treasury as miscellaneous receipts.

XVII. STATE AND LOCAL TRANSACTION AND RELATED TAXES PROHIBITED. The bill adds a new section 3a to the Commodity Exchange Act which expressly prohibits state and local governments from imposing transaction and related taxes on commodity futures and options transactions.

XVIII. CORRECTING AMENDMENT. The bill amends section 17(h) of the Commodity Exchange Act to correct a typographical error.

XIX. AUTHORIZATION FOR APPROPRIATIONS. The bill amends section 12(d) of the Commodity Exchange Act to provide authorization for CFTC appropriations for six years (through September 30, 1988).

XX. EFFECTIVE DATE. The bill provides that the Commodity Exchange Act and related amendments will become effective October 1, 1982.

STATEMENT OF LEE H. BERENDT,
EXECUTIVE VICE CHAIRMAN,
COMMODITY EXCHANGE INC.,
NEW YORK, NEW YORK

COMMODITY FUTURES TRADING COMMISSION
REAUTHORIZATION LEGISLATION

PRESENTED TO
THE SENATE COMMITTEE ON AGRICULTURE
NUTRITION AND FORESTRY

March 1, 1982

A. Introduction

Mr. Chairman and members of the Committee, my name is Lee H. Berendt. I am the Executive Vice-Chairman of Commodity Exchange, Inc. ("Comex" or the "Exchange") and I have been associated with Comex for the past 12 years, since last year in the capacity of Executive Vice Chairman and prior thereto as President.

Comex, founded in 1933, is currently the world's largest metal futures exchange and enjoys an international reputation for being one of the most accomplished futures market organizations. Comex is a designated contract market in four metal futures -- gold, silver, copper and zinc. The volume of metal futures contracts traded on Comex is more than three and one-half times the volume of metal futures traded on all other domestic exchanges combined. Gold, the most active contract traded on Comex, was the third most actively traded commodity in the United States in 1981, accounting for 10.5% of all domestic commodity futures volume. On an average, more than four million ounces of gold are traded in Comex's pits each business day.

Beside its metal futures, Comex is a designated contract market in three financial instrument futures: 90-day treasury bills, 2-year treasury notes and Government National Mortgage Association Certificates. Comex is also currently seeking designation to trade a stock index contract, options on gold futures and a gold coin contract. While still in their early stages of development, we believe that the Comex financial futures contracts represent significant steps in the Exchange's plan to build a financial futures marketplace in New York City.

B. Reauthorization and the Commission

Mr. Chairman, it is my pleasure to be appearing before the Committee as the Commodity Exchange Act (the "Act") is re-examined for the second time in connection with the reauthorization of the Commodity Futures Trading Commision (the "CFTC" or "Commission"). As I indicated in my 1978 testimony before this Committee, we at Comex do not believe that the sunset provision currently in the Act is designed to call upon Congress to re-invent the regulatory scheme for the futures industry every four years. Rather, it is our view that each of the quatraennial reviews of the regulatory scheme since 1974 has granted an opportunity to "fine-tune" the regulation of futures markets and their participants, based on the experience of regulators and regulated alike over a four-year period.

These reviews also afford Congress the opportunity to evaluate the performance of the CFTC and determine whether to continue the agency's existence. However, the process of CFTC evaluation and authorization may be submerged this year under a plethora of legislative proposals that will take an inordinate amount of the Committee's time and effort to evaluate. Before dealing with those legislative proposals, I would like to offer a few comments on the Commission itself.

Since 1978, the Commission has demonstrated that it is an important and vital federal agency. Many of the agency's problems of the mid-70's seem to be history. The Commission now consists of five Commissioners who were not part of the original Commission in 1975 but who have all demonstrated their dedication to meaningful and effective regulation. Since 1978, the Commission has confronted and dealt effectively with a number of difficult issues, including option trading, stock index contracts, the silver crisis and the jurisdictional dispute with the Securities and Exchange Commission ("SEC"). Under the able leadership of Chairman Johnson, the Commission finally appears well on its way to firmly establishing itself as a meaningful federal agency. These comments, however, should not in any way be construed to imply any Comex support for the Commission's current legislative proposals; nothing could be further from the fact. However, we do believe that the Commission is satisfying its statutory mandate and should be reauthorized.

C. Overview of Legislative Proposals

The concept of reauthorization as a time for fine-tuning a statute is rooted in an understanding of the potentially disastrous consequences which may ensue if extensive amendments to the Act are made too precipitously and with little regard for potential effects on the effective functioning of futures markets. For example, as discussed more fully below, in 1978 Congress adopted the AuCoin amendment to Section 5a(12), requiring Federal Register publication of proposals of major economic significance. The entire industry, as well as the Commission, has now recognized that the amendment has not worked, did not accomplish its sponsors' objectives and has unduly slowed down the rule approval process. Additionaly, it requires tremendous expenditures of time and money by the Commission, the exchanges and the industry.

To avoid a recurrence of this problem, Comex therefore vigorously opposes the effort by the Commission to present to Congress, during reauthorization, a complex, fifty-page package of drastic and far-reaching amendments to the Act ("CFTC Proposal").

The CFTC Proposal (H. R. 5447 and S. 2109) covers forty-five sections of the Act and an exceedingly broad range of topics, including (1) delineating the CFTC's jurisdiction relative to the SEC; (2) user fee authority; (3) providing the CFTC with rulemaking authority over foreign futures; (4) granting the CFTC authority to set speculative position limits by rule or regulation, as well as by order; (5) requiring certain principals and non-clerical workers of commodity pool operators and commodity trading advisors to register as associated persons; (6) granting the CFTC authority to set proficiency standards for all registrants, not just futures commission merchants and floor brokers; in sum, the "wish" list is immense. In presenting such a package, it is evident that the CFTC seeks not to fine-tune the Act but to adopt new measures which significantly change the regulatory scheme and which will result in dramatically increased costs for the public and the industry without any perceptible public benefits.

I note that the CFTC Proposal has been characterized by the Commission as an attempt to streamline and simplify the Act. However, the proposal would add almost 5,000 words to the Act, less than 1,000 of which relate to jurisdiction -- a strange approach to streamlining and simplification. We believe that the CFTC Proposal is not streamlining, but a dramatic legislative overhaul of the Act.

It is also evident that the CFTC is urging Congress to rush to judgment on a set of proposals that no one can intelligently analyze in the time frame provided. On one hand, it is always difficult to estimate the ripple effects which will occur as the result of any legislative action. On a more fundamental level, however, the extensiveness of the CFTC Proposal and the short time-frame for its review grants neither Congress nor the industry any opportunity to make necessary cost/benefit analyses of each measure proposed.

In this regard, it is significant to note that the CFTC Proposal seeks to increase the Commission's powers and regulatory requirements and expand Commission staff and expenditures, positions inconsistent with concepts of regulatory reform, efficiency, and economy and totally alien to the concept of self-regulation. In fact, the next CFTC budget proposes an increase of over 15%. Therefore, the CFTC Proposal is totally inconsistent with two of the Reagan administration's goals stated most recently in the President's January 26, 1982 State of the Union Message to the Nation: reducing federal spending and removing unnecessary federal regulations to spark productivity. In the face of these policies, we believe that the Commission should at least be able to cost justify each and every one of its proposals. As President Reagan admonished Federal regulators less than one year ago, regulators should issue no rule unless the potential benefits to society from the regulation outweigh the potential costs to society. As set forth more fully below, many of the Commission's proposals threaten to have just the opposite effect.

On the other hand, Comex, together with our nation's other futures exchanges and many industry representatives including futures commission merchants, the National Futures Association and the Futures Industry Association, have submitted a legislative proposal, entitled "Recommendations for a 'Futures Trading Regulatory Improvement Act of 1982'" ("Industry Proposal"). The Industry Proposal, unlike the CFTC Proposal, does not attempt to focus Congressional attention on pet projects or to rewrite the Act. Rather, the Industry Proposal is rooted in experience, and seeks only changes which appear to be cost-justified means to improve the system or to modernize and streamline the Act. Consequently, in contrast to the CFTC Proposal's 45 sections, the Industry Proposal only has 9 sections. In other words, the industry has drafted proposals to serve the purposes of the reauthorization process.

Comex wholeheartedly endorses all aspects of the Industry Proposal. Comex would therefore like to take this opportunity to explain how the exchanges' experience over the past few years has led Comex to believe that the amendments set forth in the Industry Proposal are necessary for a more efficient regulation of the futures industry, and to express its opposition to related CFTC proposals which threaten to worsen present conditions by needlessly expanding and confusing the regulation of futures markets. Comex would also like to express its opposition to several further CFTC proposals which threaten merely to increase the present regulatory burden with no corresponding benefits either to society or futures markets and their participants. I will not deal with a section by section analysis of the entire CFTC Proposal, an exercise that would unnecessarily burden this Committee. Rather I will deal with only those portions of the CFTC Proposal that are of particular interest and concern to Comex.

In addition, and perhaps by way of introduction, it is important for this Committee to understand the manner in which the futures exchanges industry responded, since 1974, to the demand for improved self-regulation. The exchanges have commited time and money to self-regulation and have satisfactorily proven that self-regulation works. In that light, it is difficult to understand the logic, necessity or desirability of the CFTC Proposal which would fly in the face of the philosophy of self-regulation and the proven ability of the exchanges to make that philosophy meaningful.

D. The Cost of Self-Regulation

In a year when the futures industry is confronted with a potential of up to $8,000,000 in dues and assessments for the National Futures Association and up to $23,000,000 in user fees to fund the entire CFTC budget, it is critical for this Committee to understand how much is currently spent by the industry on self-regulation. Recognizing that ultimately the users of the market, speculators and hedgers alike, will bear the brunt of these costs as well as the costs of exchange self-regulation, it is evident that when costs become too extreme, those users will seek out other markets which are more cost-effective. To drive futures business to foreign markets with their reduced transaction costs cannot be the purpose or goal of this Committee or the Commission, and yet, our industry is precariously close to just that situation.

Market users have funded the increased costs of self-regulation by exchanges since the creation of the Commission. In evaluating the costs to the exchanges of discharging their self-regulatory obligations, we must evaluate both actual out-of-pocket expenditures and uncompensated time expenditures of members serving on committees. On the subject of expenditures of time, we have computed that during 1981, members of Comex (not including salaried staff) dedicated over 5,000 hours to discharging Comex's self-regulatory obligations. That includes time spent by our Disciplinary Committees, Control Committee, Board of Governors and other related committees. At the Chicago Board of Trade, the time expended was over 8,000 hours.

We have also analyzed our out-of-pocket expenditures in order to develop an understanding not only of the cost of self-regulation but, also, of the extent to which those costs have increased since the Commission was created. During Comex's fiscal year ended November 30, 1976, approximately $600,000 was spent on self-regulation. During Comex's fiscal year ended November 30, 1981 approximately $3,000,000 was spent on regulation -- a 500% increase in five years. Those costs include salaries, related costs and a pro rata part of the Exchange's other direct expenses (e.g. rent, insurance, printing, etc.) for our financial audit group, our compliance and market surveillance departments and our inside and outside legal counsel. During 1981, the Chicago Board of Trade spent over $2,400,000 on salaries alone for internal departments performing regulatory functions, exclusive of all other direct expenses.

Since Comex represents approximately 15% of our nation's futures activity, simple extrapolation suggests an out-of-pocket expenditure by all exchanges of $20,000,000 for self-regulation -- the equivalent of the CFTC budget.

These statistics do not take into account the enormous expenditures, by futures commission merchants, of maintaining their own internal compliance departments designed to insure compliance with the Act and with the rules of the various exchanges.

It is difficult to understand the need for increasing expenditures for government regulation in an industry that is as demonstrably dedicated to effective self-regulation as the futures industry.

As a general summary, then, I would urge this Committee when evaluating legislative proposals, to be mindful of increased regulatory costs and suggested methods of funding those costs, recognizing, at the same time, that alternative foreign markets are available for market users. And now to a specific analysis of various features of the Industry Proposal and the CFTC Proposal.

E. The Role of the Speculator

Sections 3 and 4a(1) of the Act currently contain certain statements of purpose which are decidely biased against speculative participation in futures markets. These statements neither accord with current economic understanding of the function speculators perform in futures markets, nor are consonant with any previous legislative findings that speculators are detrimental to futures markets. Comex questions why the Commission, in its asserted attempt to streamline the Act, has retained this language without change. These misconceptions about speculators have served, and have the potential to serve in the future, as a basis for misdirected proposals to regulate speculative elements of futures markets. In fact, such a misconception lies at the base of the CFTC's sweeping proposals regarding speculative position limits. Comex therefore believes that Sections 3 and 4a(1) of the Act should be amended to eliminate certain economically unsound anti-speculative declarations. In addition, because the CFTC's proposal to impose speculative position limits by rules is based on these misconceptions, Comex strongly opposes is adoption.

1. Section 3

Section 3 of the Commodity Exchange Act currently states, in part:

> [T]ransactions and prices of commodities on boards of trade are susceptible to speculation, manipulation or control and sudden or unreasonable fluctuations in the prices thereof frequently occur as a result of such speculation, manipulation or control, which are detrimental to the producer or the consumer and the persons handling commodities and the products and byproducts thereof in interstate commerce, and that such fluctuations in prices are an obstruction to and a burden upon interstate commerce in commodities and the products a byproducts thereof and render regulation imperative for the protection of such commerce and the national public interest therein.

This statement simply does not accord with modern economic understanding of the role speculation plays in futures markets. It is well-recognized that futures transactions are "susceptible to" speculation; it is universally acknowledged that speculators are absolutely necessary to create a liquid market. The CFTC, in its 1976 Advisory Committee Report on the Economic Role of Contract Markets, recognized further that speculation is a "vital beneficial force in futures markets", noting that speculators both bridge the time gap between short and long hedgers and provide independent price judgments which aid the markets' price discovery function.

Moreover, history reveals that the provision evolved as a result of Congress's hasty effort to repair the 1921 Future Trading Act after the Supreme Court's finding in Hill v. Wallace that the act had no Constitutional basis. The events leading up to the adoption of the provision after the defeat in Hill lead to no other conclusion but that the statement which now appears as Section 3 was baseless political propaganda. First the Court volunteered in its opinion striking down the proposed legislation that the bill would be sustainable under the Commerce Clause if Congress concluded from evidence before it that the trading it sought to regulate was "directly interfering with interstate commerce so as to be an obstruction or burden thereon". Less than one month later, a new bill, the Grain Futures Act, was introduced in the House which reframed the 1921 Future Trading Act just as the Court suggested. The House Committee's Report solemnly concluded with the present language of Section 3 without submitting any evidence for its conclusions. Even contemporaries in Congress noted the discrepancy between the conclusions stated in the House Committee's Report and the facts. Nonetheless, the statement of policy was retained, without explanation, when Congress revised the Act in 1974.

Given the fact that Section 3 has at no point had a basis in fact, the anti-speculative declarations in Section 3 should not be retained, permitting the continuance of policies and administrative and judicial determinations which inhibit the commitment of speculative capital necessary to the functioning of futures markets. The acceptance of futures markets by major institutions seeking to transfer risks associated with volatility of interest rates, currencies and commodity prices requires increased participation by speculators. Artificial reasons for restricting speculative participation preclude efficient operation of the risk-transfer mechanism so vital to the Nation's economy.

So long as the anti-speculative bias remains in Section 3, there is a constant danger that this misconception about speculation will permit the passage of disastrous legislative or regulatory action based on nothing more than this false and flimsy phrase. For instance, Senator Proxmire introduced a bill in 1980 to authorize the Federal Reserve Board to establish margin requirements over financial instrument futures and based his proposal on the idea that it was necessary "to prevent excessive speculation with substantive adverse impact on the Nation's banking system . . .". No further justification was given, even though the proposal threatened to increase regulatory burdens and to affect adversely the function of futures markets. In short, the baseless anti-speculative notions in Section 3 threaten to act as catchwords justifying a whole panoply of ill-considered and unwarranted proposals. Such anti-speculative notions should be removed.

2. Section 4a(1)

Section 4a(1) of the Act suffers from the inclusion of a similar anti-speculative declaration of purpose, which threatens to bring about just this type of unjustified regulation. The section provides for the imposition of speculative position limits as a means of "diminishing, eliminating or preventing" any "sudden or unreasonable fluctuations or unwarranted changes in price" caused by "excessive speculation". This statement is based on 1930's economic thinking that large positions were less desirable than several small positions and on the general Depression Era fear of speculation. Needless to say, this economic thinking is outmoded.

Specifically, there are two assumptions implicit in Section 4a(1) which are unsupported by current market experience. The first assumption is that "sudden" "unreasonable" or "unwarranted" price movements caused by speculation can somehow be distinguished from normal price fluctuations. Experience shows that, absent evidence of market manipulation or a squeeze, they cannot. Based on this, Comex believes that the only legitimate rationale for speculative position limits is their potential for preventing manipulations or squeezes and that the purpose, statement and function of position limits should be limited accordingly.

The second assumption is that size and speculativeness are characteristics of futures positions which have the potential to influence prices. In fact, exchange experience reveals that, at the very least, this assumption is not true for all commodities. While perishable commodities may require low position limits because the supply which may be available at a future date cannot be determined, low limits are unnecessary for commodities such as previous metals because present and future supply data is readily ascertainable.

In addition, the international soft commodities such as coffee, sugar and cocoa are relatively shielded from the effects of large positions in the market by the high interdependence between futures, cash and forward markets. Moreover, in the recent silver crisis, Comex became vividly aware that commodities for which new sources of supply can be tapped, for instance, by the dishoarding of silver, are also shielded from the effects of large speculative positions. Comex has also noted that such effects are minimized when the transportation costs for the commodity are low relative to their value; metals and financial instruments are examples of commodities bearing such protections.

Based on this experience in the market, Comex believes both that the anti-speculative declaration in Section 4a(1) should be deleted and that speculative limits must be tailored to each market and thus should not be set without consideration of trading volume, open interest, deliverable supply and arbitrage possibilities. Setting such requirements should prevent two adverse possibilities: (1) the imposition of limits where natural market forces accomplish the same purpose at no cost; and (2) the establishment of speculative limits which are too low. Limits which are set too low result in reduced liquidity and an inability of the market to accommodate hedging activity. For example, if hedging in a particular market is predominantly short, and if there are long speculators who would exceed the limits if they entered into trades with these hedgers, the futures price resulting from the application of the limits would differ from that which would be dictated by market fundamentals. This would distort market forces, which is exactly what limits are supposed to prevent. In addition, if a futures contract is traded abroad, trading in the contract may be driven to the foreign market.

Moreover, experience reveals that there must be periodic review of limits, or else they will remain at unduly low levels. The speculative limits on wheat, for example, have been increased only once since 1938, i.e., from 2,000,000 bushels to 3,000,000 bushels in 1976. Even this level is undoubtedly low, given that the percentage increase in open interest between 1938 and 1976 greatly exceeded the increase in position limits.

The Commission proposal regarding Section 4a(1), however, is inconsistent with this accumulated experience in the futures markets. Retaining the outmoded "excessive speculation" justification, the Commission has suggested that it be allowed to set such limits by rule or regulation, implying that it contemplates, or at least is desirous of obtaining authority for, imposing across-the-board speculative limits, perhaps on each futures contract.

Given that there is no economic basis for the "excessive speculation" purpose retained by the CFTC in Section 4a(1), the CFTC has no justification for its proposal to impose position limits by rule or regulation. Justification is sorely needed, however, because this proposal carries the possibility of significantly increasing the regulatory burden on both contract markets and the CFTC itself. Setting position limits requires detailed market data, as well as a feel for the size of delivery that can be handled by a given market, and flexibility to adjust for changes in production, stocks, and liquidity. Unlike the Industry Proposal, which at least would limit the need for such information to instances where market conditions indicate it is necessary, the Commission, by its "rule" proposal, implies that this market data collection process would be on-going. Needless to say, this would create the need for vast amounts of data collection and processing which will significantly increase regulatory expense without any concomitant benefit and which will simply not be needed unless certain market conditions arise.

This would hardly accord with the current administration's goal "to get the government off the backs of the people" by reducing needless regulation. It also fails to "take into the account the conditions of the particular industries affected by regulations" and "the condition of the national economy" as President Reagan has admonished regulators to do. The only possible way that the Commission's proposal could avoid this type of regulatory burden is by not observing the type of market data we have urged is necessary for the creation of proper limits. No such standards appear in their proposal. Without them, the significant obstruction to proper operation of the markets discussed above may result.

3. Section 4a(5)

On a related topic, the Commission's proposal to adopt a new Section 4a(5) to the Act, permitting exchanges to adopt position limits which differ from those set by the Commission if there is Commission approval, does nothing to add necessary flexibility in tailoring such limits because no time limits are set on Commission approval and thus, exchanges may have to operate for considerable periods of time with low and outdated position limits.

This proposal also appears to provide for liability under the Act for a violation of any Commission-approved exchange rule setting position limits. Perhaps the drafting of this section was inadvertent, but this provision threatens to reverse the astute decision in Graves v. Shearson Hayden Stone, Inc. that violation of an exchange rule does not constitute a violation of the Act and thus conceivably opens the door to dual punishment for a single deed. Comex therefore opposes the Commission's Section 4a(5) recommendation.

F. Protection of Confidential Information

Exchange experience has also led to a recognition of the inadequacy of the protection provided against improper disclosure of confidential information submitted to the CFTC pursuant to provisions of the Act or CFTC Regulations.

The type of disclosure required under the Act and CFTC Regulations from contract markets as well as futures commission merchants and registrants is vast -- "[A]ll books, records, minutes and journals of proceedings" of a contract market and its "governing board, committees, subsidiaries and affiliates" must be kept and remain available for inspection and copying by the Commission -- yet third parties are able to obtain such information relatively easily. First, such information can be obtained pursuant to a court order in a judicial proceeding. No notice is given to the person who submitted the information where it is disclosed pursuant to such an order. Comex therefore endorses the amendment to Section 8(a) set forth in the Industry Proposal to provide submitters with the opportunity to prevent disclosure of information which is the subject of a subpoena served on the Commission. Comex also supports amending Section 8(b) of the Act to limit the disclosure of information listed in Section 8(a) of the Act to judicial and administrative proceedings to which the Commission is a party.

Second, third parties can gain access to confidential information submitted to the CFTC pursuant to a request under the Freedom of Information Act. The Freedom of Information Act exempts two categories of information from disclosure but these exemptions have been interpreted narrowly and are therefore woefully inadequate.

The first exemption under the Freedom of Information Act covers both trade secrets and commercial or financial information which is obtained from a person and which is privileged or confidential. Although the legislative history of this exemption indicates a Congressional intention that information would be treated as confidential if it "would customarily not be released to the public by the person from whom it was obtained", the Ninth Circuit has interpreted the confidential information exception to apply only to situations where disclosure would either impair the Government's ability to obtain information in the future or cause substantial competitive harm to the person from whom the information was obtained. Moreover, the section has been construed so as not to cover documents generated by the Commission.

The second Freedom of Information Act exemption protects information "specifically exempted from disclosure by statute", and thus invokes the limited protections of Section 8(a) of the Act for business transactions, market positions, trade secrets or names of customers. This section, by its terms, therefore does not cover audit reports of futures commission merchants, investigative files and exchange committee minutes or staff reports.

There appears to be no legislative reason to undermine the interests of parties seeking protection of sensitive information which must be submitted to the Government. Such risk of disclosure, in turn, may eventually impair the Commission's ability to obtain complete and candid information. Comex therefore supports the amendment set forth in the Industry Proposal which enumerates further types of information which the Commission would be precluded from disclosing (other than pursuant to a subpoena or summons).

Commendably, the Commission's proposal for amending Section 8(a) and (b) of the Act recognizes, in part, the inadequacies discussed above, for the Commission proposes extending protection against disclosure under Section 8(a) of the Act to "data or information concerning or obtained in connection with any investigation of any person". Unfortunately, the amendment to Section 8(a), as drafted, does not seem to make sense. Under the CFTC Proposal, Section 8(a) would provide that the Commission may "make such investigations as it deems necessary to ascertain the facts regarding the operations of boards of trade or other persons subject to the provisions of the Act", and "may publish from time to time the results of such investigation . . .: Provided, That except as otherwise specifically authorized in the Act, the Commission may not publish . . . data or information concerning or obtained in connection with any investigation . . .". In sum, the Commission's provision comes full circle, saying that the CFTC can investigate and publish the results of the investigation so long as it doesn't reveal data obtained as a result of the investigation. The proposal is typical of many of the other hastily contrived features of the CFTC Proposal and would serve merely to create further ambiguity in the Act without solving a problem which is worthy of solution.

Moreover, if the Commission's proposed technical amendment to Section 16(d) of the Act is intended to make that section parallel to Section 8(a), the Commission neglected to include in Section 16(d) the all-encompassing "data and information concerning or obtained in connection with any investigation" exception placed in Section 8(a). The current inclusion of a parallel provision to Section 8(a) in Section 16(d) in the Act suggests that market investigations under Section 16 may yield the same types of sensitive data as an investigation pursuant to Section 8(a). Nonetheless, should the Commission obtain an exchange committee report containing information about the effects of certain competitive policies of that exchange which have led to a better price-discovery function during a Section 16(a) investigation, no protection against disclosure would be provided.

This is not the only oversight the Commission has made in its blunderbuss approach to amending certain sections of the Act regarding the disclosure of potentially confidential information. As noted above, the Industry Proposal urges that amendments be drafted to Section 8(a) to assure that the person from whom information was obtained has the opportunity to be notified if the information is sought pursuant to a subpoena and to challenge the disclosure of such information. The Industry Proposal also recommends amending Section 8(b) to limit the Commission's power voluntarily to disclose Section 8(a) information during a judicial proceeding to those proceedings to which the Commission is a party. This prevents the protections of Section 8(a) from being circumvented by the Commission's voluntary disgorgement in private proceedings, a danger which surfaced in

CFTC v. Nelson Bunker Hunt, et al., where the CFTC publicly disclosed the soybean trading activity and positions of market participants contemporaneously with issuing a complaint against those participants for exceeding speculative position limits on soybean contracts. This action not only damaged those participants but had a devastating impact on all market participants that had similar positions.

In contrast, the Commission's wide-sweeping proposal to amend Section 8(e) of the Act opens up three new fronts on which disclosure of confidential materials submitted to the Commission may be achieved. First, by expanding the range of Federal agencies which may request information from the CFTC beyond those in the Executive Department, the number of agencies which may, in turn, disclose confidential information in a judicial proceeding is expanded. Second, by allowing state or foreign governments to obtain confidential information from the CFTC in regard to any state or foreign proceeding to which such state or foreign government is a party, the CFTC has opened submitters of information to a greater possibility of disclosure. Moreover, a foreign government suing a private citizen first in the foreign state and then in the United States could obtain information under the proposed amended Section 8(e) in the first proceeding simply because it wishes to use it in the second.

In sum, a panoply of loopholes will be created under the Commission's proposals. Thus, even here, where the Commission appears to recognize the paucity of disclosure protection currently available, the ramifications of its complex scheme of amendments appear likely to undermine its constructive goals. Therefore, not only does Comex specifically oppose the Commission's proposals regarding amendments to Sections 8(a), 8(b), 8(e) and 16(d) of the Act, Comex also reiterates its view that the Committee should proceed cautiously in considering the complex package of amendments to existing sections, and proposed new sections, which the CFTC urges it to adopt within the strict timetable of the reauthorization proceedings.

G. Approval Procedures Must Be Streamlined

1. Rule Approval

CFTC review of exchange rules under Section 5a(12) has been a constant source of well-recognized problems for the effective administration of contract markets.

Time delays are the chief problem and can be traced to two sources. First, although Section 5a(12) sets time limits for approval of proposed rules, the CFTC can defer indefinitely the rule approval process merely by notifying the exchange that it is unable to make a determination within the specified period. In addition, the statute requires the CFTC to determine which proposed rules are of "major economic significance" and to publish such rules for public comment before approving them. This constitutes another source of considerable delays.

Second, although Commission approval is only required of those contract market rules which "relate to the terms and conditions in [futures contracts] . . . or relate to other trading requirements except those relating to the setting of margin", the Commission has interpreted this grant of authority as an "all pervasive . . . authority" over "exchange management decisions", including "day-to-day decisions". In practice, the Commission has required review of an exchange rule requiring members to wear proper attire on the floor of an exchange on the ground that this constitutes a "trading requirement", since without such attire, a member may not trade. A CFTC staff member has even maintained that an exchange resolution to compensate members of a committee which decided to give money to the Boy Scouts is a reviewable rule. Clearly these interpretations represent an attempt by the CFTC to expand its authority beyond its statutory limits. Exchanges have been impacted, however, in that every little rule must await the CFTC's lengthy review process, thus hampering effective exchange regulation.

Without implying any criticism for the current Commission, and while many of the rules submitted to the Commission have been reviewed in less than the statutory 30-day period, it is evident from some of the delays Comex has experienced in having its rules reviewed that the potential for delays is a very real one which is ripe for correction.

For example, on June 18, 1980, Comex submitted to the CFTC rule amendments to combine its Committee on Financial Instruments with its Committee on Registered Banks. The amendments were approved on February 9, 1981 -- over seven months later. On December 23, 1980 Comex submitted to the CFTC a proposal to split its seats. The proposal was approved on May 13, 1981 -- over four months later. On March 16, 1981, Comex submitted to the CFTC an amendment to its original margin rules requiring marking for spot positions. The amendment was approved on July 23, 1981 -- four months later. The CFTC still has not approved a December 2, 1981 rule submission which would authorize the Compliance Department to issue warning letters.

A more insidious problem is a practice the CFTC has developed of using further time delays as a means to impose its own thoughts on exchange rules. Although the only ground upon which the Commission may disapprove a proposed exchange rule under 5a(12) is a violation of the Act or the Regulations thereunder, in practice the Commission uses the implicit threat of rule approval time delays as a bargaining tool to obtain changes to such rules based on draftsmanship, manageability, and policy -- standards of review which are not prescribed under the Act. Since the Commission is not required to state the basis of its decision of disapproval under Section 5a(12), there is no way for an exchange to combat these abuses.

Comex joins all the other exchanges submitting the Industry Proposal in recommending three simple amendments to Section 5a(12) to remedy the time delay problem. First, Comex endorses the imposition of enforceable, but realistic, time limits. Specifically, Comex recommends that the CFTC be required to approve a rule or bring a disapproval proceeding within 60 days of receipt. If the CFTC fails to act within the limits or fails to complete a disapproval proceeding within 180 days, the exchange would be free to implement the rule.

Second, Comex supports the Industry Proposal to eliminate the major economic significance determination from the rule, to diminish the further time delays which exchanges have experienced under the Act. The lack of public comment solicitation which would result would have negligible effects because the public rarely comments on the proposed rules in any event. Our review of the comments filed with the Commission on the eight Comex rules which have been published in the Federal Register revealed that only two members of the public submitted comments on the proposed rules. A review of the files of proposed rules of other exchanges which have been published for comment undoubtedly would reveal a similar paucity of comments.

The results of this survey should not be surprising. Exchange rules, especially those of economic significance, are not arbitrarily adopted. Rather, the development of a rule is preceded by consultation with exchange members from every facet of the industry and such rule is forwarded to the Commission only upon approval of the exchange board of governors which also is representative of the various groups within the industry. Consequently, no rules are submitted to the Commission which do not have the support of those who most frequently use the markets.

Third, Comex supports the suggested amendments which would limit prior Commission review of proposed rules to those which have a significant impact on market participants. To accomplish this objective, the industry amendment would limit the bylaws, rules, regulations and resolutions that are subject to Section 5a(12) review to those "which embody policy of general applicability to market participants". This language would confirm that Section 5a(12) does not apply to actions concerning persons who are not market participants (e.g., employees or members of boards or committees, when functioning as such), to actions involving the use of exchange facilities (such as rules of decorum) or to procedures implementing approved rules (such as the format of clearing submissions). Not only does this decrease the regulatory burden but it does so by focusing Commission attention on matters of some importance in the markets and removing the need for approval of purely administrative details.

In contrast, the CFTC's proposal as drafted does nothing to solve the recognized time delay problem. To begin with, the CFTC appears to want to cast into stone its expansive and statutorily unwarranted interpretation of "reviewable rules."

The CFTC's suggested amendment to Section 5a(12) requires the prior submission to the Commission for approval of the following:

> . . . all by-laws, rules, regulations, and resolutions ("rules") made or issued by such contract market, or by the governing board thereof or any committee thereof, which are of major economic significance, or which relate to terms and conditions in contracts of sale to be executed on or subject to the rules of such contract market, as such terms and conditions are defined by the Commission by rule or regulation, except those rules relating to the setting of levels of margin.

The Commission's proposal then goes on in the next line to state "Each contract market shall submit to the Commission all other rules (except those relating to the setting of levels of margin) . . ." (emphasis added) and provides that such rules will be subject to certain time limits.

The proposal therefore appears to speak in terms of three types of rules: 1) those of economic significance; 2) those which relate to the terms and conditions in contracts of sale to be executed on the exchange; and 3) "all other rules". It appears, by reference its to "all other rules", that the CFTC aims to continue its policy of reviewing exchange rules, regulations and resolutions which are currently beyond its statutory powers of review. This change could have a crippling effect on the ability of markets to adopt necessary rules solely related to exchange administration.

Given the vast backlogs which now occur, Comex questions what time delays will ensue when all such trivial rules are submitted. Moreover, Comex questions why such rules should be reviewed. Given the vast regulatory burden which will result, Comex submits that the CFTC has not cost-justified the inclusion of additional rules. What marginal value will result and at what cost to the American taxpayer?

The CFTC has also failed to solve the lack of time limits in Section 5a(12). The CFTC appears to recognize the time delay problem, but has failed miserably to correct the problem as a result of faulty drafting and a failure to recognize the source of the time delays. For instance, the CFTC has recommended a 10-day time limit for the CFTC to notify an exchange if it intends to review any rule which is of the type referred to as "all other rules". If the Commission gives such notification, however, the CFTC's amended rule further provides that "[t]he Commission shall approve rules . . . ., within thirty days after the Commission determines to review for approval any other rules . . . unless the Commission notifies the contract market of its inability to complete such approval or review within such period of time". In other words, by sending two notices, instead of one, the Commission will rid itself of all time limits on rule approval reviews. Not only is this senseless, but, if you assume that the CFTC will actually be making these determinations 10 days and then 30 days from receipt, the proposed amendment represents an increased regulatory burden.

The CFTC proposal also blindly retains the requirement of prior publication of rules of major economic significance. The CFTC has, however, provided only for publication of a "notice", rather than the full text of economically significant rules. The time delay, of course, stems not from the time it takes to print the rule in the Federal Register but from the time it takes the agency to make a determination of economic significance. The CFTC's amended Section 5a(12) also requires the CFTC to approve such rules within 60 days of the determination that it is a rule of economic significance rather than within 60 days from receipt of the rule. Despite this provision, the CFTC fails to put an effective time limit on the approval process by allowing the CFTC to notify an exchange that it cannot meet the 60-day deadline. In sum, the CFTC proposals do nothing to cure the acknowledged time delay problem.

Moreover, further problems stem from the indefinite drafting of the amendment to Section 5a(12). Since there is no time limit on the CFTC's determination of whether a rule is of economic significance, but "all other rules" become effective within ten days of CFTC receipt unless the Commission notifies the exchange otherwise, there is a significant danger that an exchange may not consider a rule of economic significance and therefore may implement it within 10 days of its submission to the Commission. Thereafter, the CFTC may determine the rule to be of economic significance and the exchange would be in violation of Section 5a(8) since the rule had not truly been approved pursuant to Section 5a(12).

Finally, the CFTC's proposal fails to include procedural safeguards to assure that the Commission disapproves rules on the statutory basis -- that is, that the rule is in violation of the Act or the Regulations thereunder. The Commission is currently not required to make findings in disapproving an exchange rule or to specify the section of the Act or Regulations that the rule violates. There is therefore no way for an exchange to determine if the Commission has complied with the statutory mandate regarding the standards for rule reviews. This is simply Kafkaesque and untenable in a modern society. Therefore, the Exchange recommends that the Act be amended to require that each rule disapproval be supported by specific findings that the rule is the type of rule subject to the approval process and that the rule is in violation of specific provisions of the Act or the Regulations.

Comex also endorses the adoption of a provision granting the Exchange a "hearing on the record" in any disapproval process and notification prior to such hearing of the grounds for disapproval of its rule. As noted below, the CFTC has painstakingly provided the SEC with a hearing which is transcribed if the SEC challenges the CFTC's designation of a board of trade as a contract market for a stock index futures contract. Comex questions why the Commission is so reluctant to accord the same procedural safeguards to members of the futures industry. Without such an amendment, the Kafkaesque practices which have evolved at the Commission will continue.

2. Contract Market Designation

Despite the extensiveness of the CFTC's legislative proposal, the Commission has ignored an area in which it appears that the regulatory burden on both the CFTC and exchanges could be significantly reduced--the process of contract market designation. As discussed below in regard to stock index futures contracts, the CFTC proposes measures which threaten even further delays in a slow and economically unjustified review process.

Section 5(g) of the Act currently provides that the CFTC may designate a board of trade as a contract market:

> When such board of trade demonstrates that transactions for future delivery in the commodity for which designation is sought will not be contrary to the public interest.

The legislative history of Section 5(g) suggests that Congress meant this standard to be a liberal one. When the House passed the Commodity Futures Trading Commission Act of 1974, Section 5(g) provided that each board of trade, as a prerequisite to designation as a contract market in a particular commodity, would have to demonstrate that the contract would be used by producers, merchants or consumers for hedging or pricing of transactions in the underlying commodity on more than an occasional basis. As explained in the Report of the Committee on Agriculture, this requirement was not intended to inhibit the development of new contracts:

> [t]he Committee intends that useful and beneficial new contracts be encouraged, rather than discouraged. Thus, to reconcile doubt as to economic justification of a given proposed new contract, the Commission should look to the marketplace as an economic justification of the contract or proposed contract in question.

Later, the Senate and then the Conference Committee amended Section 5(g) to its present form. Nonetheless, it is clear from the remarks of former Senator Carl Curtis, the then-ranking Member of the Committee on Agriculture and Forestry, that this broader test, which was to include the economic purpose test of the House bill, was not intended to vest significantly greater authority in the Commission. During the floor debate on the bill, Senator Curtis said:

> It is important that this new Commodity Futures Trading Commission act as a referee and does not inject itself into the marketplace except to make certain that there is no fraud or manipulation.

Despite this legislative history, the CFTC promulgated Guideline 1 pursuant to Section 5(g). This guideline essentially engrafts additional non-statutory criteria for contract market designation onto the Act. As a result, an exchange seeking contract market designation today must show not only that the contract is not contrary to the public interest but also that the contract has an "economic purpose" and that it is commercially viable. The exchange must also justify individual contract terms and conditions. Proposed revisions to Guideline 1 would add to these burdens. Among other things, the exchange would have to make certain showings in regard to the underlying cash market for the proposed futures contract and to consider currently designated contract markets with similar commodity specifications. Needless to say, generating such data also generates considerable costs to the exchanges.

Such costs seem unwarranted given that economic theory regarding innovation indicates that free market forces sufficiently regulate this field. Empirical studies recently reported by Dr. William L. Silber of New York University in his article, "Innovation, Competition and New Contract Design in Futures Markets", suggest that the characteristics which are common among successful contracts can only indicate that one factor is significant and cannot provide grounds for predicting what may be the most successful form of that factor.

For instance, in one of the three empirical studies designed by Dr. Silber to isolate such factors, it was immediately evident that the varying success of the four different gold contracts which were introduced almost simultaneously in 1975 depended on size. The Chicago Board of Trade's 3 kg. contract and the New York Mercantile Exchange's 1 kg. contract (and higher fineness requirements) at their best reached only 1/6 of the trading volume of the 100 oz. Chicago Mercantile Exchange and Comex gold contracts. As a result, the Chicago Board of Trade eventually introduced a 100 oz. gold contract. In the first five months of 1981, however, the Chicago Board of Trade only traded 1,431 contracts of 100 ounces compared to Chicago Mercantile Exchange's 192,145 and Comex's 695,716. Who could have guessed, however, that a 100 oz. gold contract would be favored over a 3 kg. gold contract? This suggests that prior regulatory review of contract composition is unnecessary and could thwart optimal contract design.

Such review also appears unnecessary in view of the fact that, overall, an exchange's goals mesh with those of the public since an exchange's goal is to maximize the public's acceptance and use of a new contract. There are two areas which are exceptions to this general rule and for which the costs are borne solely by the public. The first is market surveillance, but this is currently policed by the CFTC. The second is low volume or dormant contracts because investors may not be able to liquidate positions in these contracts easily. However, the correct solution to the illiquidity problems arising from low volume or dormant contracts would be to impose a duty on brokerage firms to protect naive investors by advising them against investments with potential liquidity problems.

Moreover, prior Commission review of the viability of new contracts seems misplaced because the social costs of generating too many varieties of futures contracts appear to be trivial in light of the benefits.

The social benefit from innovation rests in the lower transaction costs in terms of price discovery and availability associated with futures contracts as opposed to forward contracts. The social costs of innovation are development costs, borne solely by exchanges, and the reduction in liquidity imposed on existing related contracts because there are close price correlations between existing and new contracts. This reduced liquidity problem creates very little social cost, however, since hedgers can take offsetting positions in the new contracts, thereby approximating the integration achieved by arbitraging.

Given the difficulty of determining when a contract will be successful, it appears that Guideline 1 probably will not succeed in reducing contract failure. In other words, there is no justification for such lengthy review. On the other side of the balance, however, the administrative delays involved are disturbing. Data collected from 1975 to 1979 on delays from first submission of contract proposals to the date of the first comment by the Commission (a pure administrative delay) reveals that the average administrative delay is 124 days. Comex, in fact, experienced the worst administrative delay during the period surveyed, waiting 525 days for the CFTC's first comments on its 2-year Treasury Note contract proposal. In view of the incentives to exchanges to design contracts which maximize public use, such delays seem unwarranted, especially since exchange development strategies internalize almost all private and social costs.

Consequently, Comex views the area of contract market designation as one which could be left to free market forces. If the area must be regulated, however, Comex believes that the standard for review should be a simple inquiry into whether the contract can be used to perform a hedging or risk-management function by permitting the transfer of the risk of price fluctuations from producers and consumers to speculators. If such a standard must be adopted, Comex also urges Congress to adopt a reasonable timetable for the Commission to conclude its reviews. Comex supports a 6-month timetable from the date of filing the application for designation and also urges Congress to place a cap of 30 days after the filing of a request or a disapproval hearing in order to prevent the Commission from having unlimited time for approval or disapproval.

3. SEC's Veto Power Over Index Futures

Closely related to the contract market designation and rule approval points discussed above is the topic of the rights granted to the SEC in regard to stock index futures under the CFTC's proposed Section 2(a)(1)(B) of the Act.

Although Comex commends the Commission for negotiating a jurisdictional accord with the SEC, Comex believes that the way in which the accord has been struck has created some very serious problems. Comex therefore cautions the Committee to review carefully the CFTC/SEC suggestions to Congress regarding jurisdiction just as the Committee would consider any other legislative proposal. Caution is particularly well advised in light of the fact that this Committee may adopt the CFTC/SEC legislative proposals regarding jurisdiction while the Committee with jurisdiction over the securities industry may not. The Committee may therefore face the unhappy prospect of making jurisdictional compromises without any concomitant benefits.

The Commission's legislative recommendation regarding stock index futures is one of the Commission's jurisdictional proposals which raises serious problems for Comex. In the first place, this amendment threatens to increase the layers of bureaucratic review where it is completely unjustified and where this Committee's previous approach to seeking inter-agency cooperation has worked. In 1978, for instance, the Federal Reserve Board and the Treasury had qualms about the proliferation of financial futures contracts, but those qualms were mollified by means of the statutory mandate imposed in 1978 for cooperation between government agencies. As a result of that mandate, the CFTC has constantly met with other agencies on issues of material concern and has taken into account the views of those agencies in resolving issues about contract designations. In fact, the Commission never designated a contract over any objection of the Federal Reserve Board or the Treasury. In addition, the proposal fails because it is a cumbersome approach and creates the possibility for dilatory tactics which would grant the SEC a virtual veto power over exchange designation in stock index futures.

The chief reason that the CFTC proposal fails is that again, the CFTC has not succeeded in placing sufficient limitations on the time the SEC has to challenge a stock index future which is not to its liking. Although the proposal does specify both that the SEC must object to a board of trade's designation as a contract market within 15 days after the close of the public comment period and that an oral hearing must be held thereon not less than 30 nor more than 45 days after the close of the public comment period, these time limits may prove ineffectual because: 1) the oral hearing may be held at some other time than within the 30 to 45 day time period if "the Commission and the Securities and Exchange Commission otherwise agree"; and 2) the SEC is given the right to judicial review--a process known for time delay abuses.

Moreover, the amendment the CFTC has drafted suffers from more substantive faults which threaten unnecessary delays in the review process. At least two of the standards which a contract on a stock index must meet, listed in proposed Section 2(a)(1)(B)(ii)(b) and (c), are too broad and indefinite and therefore do not constitute guidelines specific enough to prevent the SEC from holding up a board of trade's contract market designation in a stock index futures contract.

First, subsection (c) provides that the index of securities on which the proposed contract shall be based shall be a "widely published measure of, and shall reflect, (sic) the market for all publicly traded equity or debt securities or a substantial segment thereof, or shall be comparable to such measure". Just viewing the proposals presently pending at the CFTC, it is unclear which contracts meet this standard. Only three of the proposed stock index futures contracts -- the Standard and Poor's 500 Stock Index futures contract proposed by the Chicago Mercantile Exchange, the Comex 500 contract proposed by Comex and the Kansas City Board of Trade's Value Line Average Stock Index futures contract recently approved by the CFTC -- appear likely to meet the widely-published, broadly-based index criterion. The Chicago Mercantile Exchange contract is based on the widely-disseminated and well-established Standard and Poor's 500 Index, the Comex contract on a similar index and the Kansas City Board of Trade contract on the similarly well-established Value Line Index.

In contrast, both the New York Futures Exchange, Inc. and Chicago Board of Trade propose stock index futures contracts on more narrowly-based sets of stocks. The New York Futures Exchange, for instance, has proposed contracts on the New York Stock Exchange ("NYSE") Transportation Index (based on 20 stocks), the NYSE Utility Index (based on 15 stocks), the NYSE Financial Index (based on 30 stocks), and the NYSE Composite Index (based on 65 stocks). The Chicago Board of Trade has proposed futures on ten industry indexes, each based on the stock of five representative companies, and a composite index. Without further clarification of the requirement that the index be a widely-publicized measure which broadly reflects the market for equity and debt securities, it appears likely that the proposed New York Futures Exchange and Chicago Board of Trade index futures will not escape a SEC jurisdictional challenge.

Second, and perhaps more important, it is totally unclear how it can be determined if the standard set forth in subsection (b) can be met--that is, how a board of trade can show that "[t]rading in [the proposed] contract (or option on such contract) shall not be readily susceptible to manipulation of the price of such contract (or option on such contract), nor to causing or being used in the manipulation of the price of any underlying security, option on such security or option on a group or index including such securities"? Perhaps what the CFTC is aiming for is some indication that the index is widely enough based to prevent such manipulation, in which case this provision is redundant and merely provides a stalling device for the SEC. If there is true interest in the efficient review of contract market applications for designation, the information sought should be more clearly spelled out. Otherwise, the process of asking for additional information--which the CFTC does even now in its contract designation process--could bog down the review process in an unnecessary regulatory morass.

The seriousness of the time delay problem caused by the lack of time limits and imprecise criteria set forth in the CFTC's proposed amendment is highlighted by the time exchanges have already waited for contract market designation in proposed stock index futures. Stock index applications have been pending at the CFTC since 1978. These delays are incredible and unnecessary, not only because the review process is economically unjustified but also because the CFTC has the power to oversee trading in designated contract markets once it has begun.

In addition, significant exchange resources have been expended in developing the proposals presently pending at the CFTC. Not knowing when approval could have been forthcoming over the past few years, resources have also been expended on developing the capacity to accomodate the trading and compliance measures necessary for the specific proposals now pending at the Commission. Now that the rules may be changed mid-stream, more exchange monies will have to be devoted to such projects and original cost estimates will be grossly out of line. Surely, this is not a streamlined regulatory scheme that the CFTC proposes; it is an administrative nightmare.

Comex therefore believes that Section 2(a)(1)(B), as proposed by the CFTC, should be amended as follows: 1) the Act should provide that no stay, injunction or restraining order may be entered suspending the Commission's action in designating a board of trade as a contract market in a stock index futures in any proceeding in which the SEC seeks judicial review of such a determination; 2) the "widely published measure" requirement be defined to refer to the number and type of stocks which would be acceptable; and 3) the "manipulation" standard should be deleted or amended to specify the type of showing required.

Finally, I would like to point out three further flaws in the Commission's proposal. Section 2(a)(1)(B)(iii) provides that the SEC shall be granted an oral hearing "to be transcribed" before the Commission if it objects to the designation of a board of trade as a contract market in a stock index futures on the ground that any of the three requirements set forth in subsection (ii) are not met. First, it is not clear that the SEC must specify before the hearing which one of those three requirements is not met. Second, although the SEC at the end of this section is given the right to participate in any disapproval hearing on such a contract pursuant to Section 6 of the Act, an exchange is not given a right to participate in the SEC's oral hearing. Finally, as noted previously, the CFTC has painstakingly provided the SEC with an oral hearing which is transcribed whereas an exchange, under Section 5a(12), cannot even know the basis for rule disapprovals. Clearly the CFTC's amendments are haphazard and ill-considered.

4. "Foreign Currencies" Must Be Defined

The amendments to the Federal securities and commodities laws concerning options on foreign currencies which have been proposed pursuant to a jurisdictional agreement between the SEC and CFTC are uniform in their cavalier approach; nowhere is the term "foreign currency" defined. Moreover, given that the SEC is granted jurisdiction over options on foreign currencies traded on national securities exchanges and the CFTC is granted jurisdiction over options on foreign currency futures traded on national commodities exchanges, each agency can effectively obtain jurisdiction by bootstrapping. This again is a clumsy and ill-considered provision with unfavorable ramifications Comex believes the CFTC may not have begun to consider.

Comex is particularly concerned that options on gold and silver coins may be construed as options on foreign currencies instead of options on commodities or on physicals. Comex believes that gold and silver coins should not be viewed as foreign currencies, however, since the value of the coins derives from their gold content, not from their minimal currency value.

For example, the value of a South African Krugerrand, in terms of the United States dollar, is not determined by South Africa's inflation rate relative to the United States' inflation rate nor by any factor which affects the exchange rate for South African dollars and United States dollars. The Krugerrand is not some multiple of South African dollars. It is not even freely converted into South African dollars at some fixed rate for it is not a form of currency the way, for instance, a French franc is. Indeed, the value of a Krugerrand lies in the fact that it contains one troy ounce of gold and thus has an inherent value relative to the price of gold bullion. The Krugerrand's value, relative to a $100 bill, is dependent on the value of gold relative to the $100 bill. Similarly, "The American Eagle" gold coin which the United States Gold Commission recently recommended that the government mint would be sold only for its gold content, would not be redeemable in dollars and would not be dollar-denominated. Other specified amounts of certain commodities, such as a bushel of wheat, a metric ton of barley and the like, also have value relative to the price of wheat or barley in terms of the $100 bill. As such, the Krugerrand or the proposed "American Eagle" coin are commodities just as these agricultural products are commodities. As the Gold Commission's determination of the status of "The American Eagle" coin points out, the fact that the one commodity may be viewed in some instances as legal tender while others are not merely reflects legislative whim.

Comex therefore believes that the term "foreign currency" should be defined in the amendments to the Federal securities and commodities laws to exclude silver and gold coins. The need for CFTC jurisdiction is buttressed by practical considerations. An option on gold coins may directly impact on the cash market for gold since prices for both are based on the value of the physical commodity. Therefore the options market carries the potential to distort the futures market, especially as futures and cash prices converge in the delivery month. The current CFTC/SEC proposed amendments also raise the potential for manipulation and abuse of inside information by bifurcating the regulation of gold coin options and trading of the physicals. By disbursing authority, such a system impedes effective oversight and policing of improper trading activities.

H. Regulatory and Review Roles Must Be Preserved

1. Judicial Review of CFTC Emergency Determinations

Although Section 8a(9) does not refer to the issue of judicial review, the Seventh Circuit has held that the CFTC's determination of whether an emergency exists is a matter committed to "agency discretion" and, thus, is immune from judicial review.

Although there is no question that the CFTC must have the power to respond appropriately to a genuine market emergency, the enormous potential impact of such vast power requires that the CFTC be held accountable for its use. Judicial review would merely permit a federal court to supply an essential "check", one of the fundamental concepts in American democracy.

The exchanges, as self-regulatory bodies, also have a role to play in this regard. Disputes over whether an emergency exists within the meaning of the Act are likely to occur. The Commission's response to the United States embargo on grain sales to the Soviet Union is illustrative. In that instance, the Commission determined that an "emergency" existed as the result of the embargo, and, on January 6, 1980, suspended trading of all grain futures on the Chicago Board of Trade, the Minneapolis Grain Exchange, the Kansas City Board of Trade and the Mid-America Commodity Exchange. The grain embargo, in the CFTC's view, engendered a situation which prevented the market from accurately reflecting the forces of supply and demand. The exchanges affected by the order disagreed, believing that the embargo merely changed the levels of supply and demand and that the market was capable of reflecting these forces.

Although judicial review will prevent abuses by the Commission, it will still permit it to respond promptly and effectively to a true "emergency". The Administrative Procedure Act will require the party seeking review to demonstrate that the Commission's action was "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law" before a court could enjoin the Commission from exercising its emergency powers. Moreover, there is a presumption that agency action is valid and the burden of overcoming that presumption is on the party challenging the action. Even if the party meets this burden, the agency action will be affirmed if there is a rational basis for it. Thus the Commission's determinations could not easily be reversed; the Commission would merely be charged with the duty to provide a reasonable basis for its actions.

In other words, Comex believes in a system of checks and balances in which all persons affected (CFTC, exchange, market participants) may seek an impartial judgment that the CFTC is at least acting reasonably.

2. Reauthorization Cycle

Given that Congress will already have had two opportunities to improve and streamline the Act as a result of the current and 1978 reauthorization procedures, Comex also believes that the expensive, time-consuming process of reauthorization is not justified every four years. In this regard, Comex also believes that such frequent reauthorization proceedings may prevent the CFTC from being able to implement long-term policies and that proposals to overturn regulatory decisions may be placed before Congress rather than testing the rationale for agency action by experience and the judicial process.

Comex also fears that periodic reauthorization may be equated with approval of the regulatory practices of the CFTC and of various judicial and administrative decisions, merely because Congress cannot (and should not) completely review the regulatory structure of a very complex industry in the short span of the reauthorization proceedings.

Finally, and perhaps most important, the frequent focus on the reauthorization deliberations has a severe negative impact on the functioning of the CFTC, primarily because the CFTC is unable to focus its full attention on its regulatory responsibilities. Rather, extensive staff and commission member time is devoted to the legislative process. Certainly the CFTC's extensive 50-page proposal to amend the Act is indicative of a severe diversion of regulatory activities. Comex therefore supports amending Section 12(d) to provide for 6 years of appropriations for the CFTC.

3. Private Rights of Action

The issue of whether there should be private rights of action under the Act is one which is frequently discussed and debated. Comex strongly opposes any attempt to place any provision in the Act allowing for private rights of action against boards of trade. In the first place, the private rights of action issue is currently before the Supreme Court in the cases of *New York Mercantile Exchange v. Leist*, *Merrill Lynch Pierce Fenner & Smith Inc. v. Curran*, *Clayton Brokerage of St. Louis, Inc. v. Leist* and *Heinold Commodities, Inc. v. Leist*. It seems advisable to allow the Supreme Court to reach a decision on the issue of private rights of action in the cases pending before it prior to taking any legislative action. Congress will thereby have the opportunity to review in full the Court's exploration of the issues and the reasons for its decision.

In addition, there are significant policy reasons for not creating a private right of action against contract markets. An examination of the legislative scheme of the Act shows that two of the chief purposes of the statute are (1) to vest in the CFTC plenary control over contract markets and (2) to limit contract markets' exposure to monetary liability. Implication of a private cause of action for damages against a contract market would upset the entire regulatory scheme established by the Act in 1974. It is the Exchange's view that this CFTC proposal, like their stance on the review of emergency rules and the length of time currently allowed until the next reauthorization is required, threatens to endanger the proper functioning of the current regulatory scheme.

Under the Act, the CFTC is currently vested with plenary control over contract markets. The Act gives the CFTC numerous powers over contract markets, including the following: (1) to review and approve all contract market rules; (2) to alter or supplement such rules; (3) to supervise contract specifications; (4) to specify trading limits; (5) to review, affirm, reverse or modify contract market actions; (6) to inspect books and records of contract markets; (7) to investigate contract market operations; (8) to declare an emergency, ex parte, and direct contract markets to take specified action; (9) to seek injunctions against contract markets; (10) to issue cease and desist orders against contract markets; (11) to impose civil penalties; and (12) to suspend or revoke the designation of a contract market.

Implication of a private right of action would hinder the CFTC in its efforts to exercise plenary control over contract markets. Superimposed over the existing statutory framework, private rights of action would effectively disperse the CFTC's oversight powers among the 91 district courts around the country. Inevitably, this would lead to differing judicial determinations as to standards of exchange responsibility. In this manner, exchanges could conceivably be subject to differing standards which would place them in numerous, though possibly unintended, Catch-22 situations. Clearly this would have profoundly adverse effects on an exchange's ability to perform its self-regulatory functions.

An examination of the current statutory scheme also reveals that another purpose of the Act is to limit contract markets' exposure to monetary liability. For example, when the CFTC assesses civil penalties against a contract market, the CFTC is mandated by Section 6b of the Act to consider". . . whether the amount of the penalty will materially impair the contract market's ability to carry on its operations and duties . . .". Moreover, the civil penalties exacted from a contract market in a particular case can amount to a maximum of only $100,000.

Other provisions of the Act support the view that one purpose underlying the Act is to limit contract markets' exposure to monetary liability. Among these are that contract markets are not subject to reparations proceedings, state-instituted civil actions or arbitration proceedings. To allow private rights of action would truly upset the apple cart. It is also difficult to imagine why contract markets should be subject to suit in one forum (judicial) and not in the two speedier forums (arbitration and reparations). Clearly this is not a legislative measure which should be taken precipitously as the CFTC would like.

The reasons why Congress originally sought to limit contract markets' exposure to monetary liability are readily apparent. Contract markets like Comex are not profit oriented or profit-making businesses. They are not-for-profit, quasi-public institutions that work under close scrutiny of the CFTC to provide a fair and efficient marketplace for futures trading.

Moreover, protecting futures markets from extensive liability is even more crucial than protecting securities markets from such liability. Unlike securities, which can be traded in private transactions or in the over the counter market if an exchange becomes disabled or disenfranchised, futures contracts can only be traded on an organized board of trade designated as a contract market in the particular futures. Therefore, if unlimited liability placed an exchange in the position of being forced into liquidation, the ramifications would be felt throughout the economy since the hedging and price discovery function for commodities traded on that market may not be performed by any other domestic marketplace. Clearly, even the potential for such a collapse would be enough to discourage foreign trading and perhaps drive current futures trading abroad. In sum, the possibilities of disaster from superimposing private rights of action against contract markets on the current statutory scheme are endless and Comex urges Congress not to consider such a potentially harmful provision.

4. Double Jeopardy

Section 8c(2) of the Act authorizes the Commission to review "any decision by an exchange whereby a person is suspended, expelled or otherwise disciplined or denied access to the exchange". In addition, Section 8c(3) currently provides that the Commission may "affirm, modify, set aside, or remand any exchange decision it reviews pursuant to subsection (2), after a determination on the record whether the action of the exchange was in accordance with the policies of [the] Act". To perform this function, the CFTC has promulgated Regulation § 9.34, allowing the CFTC access to the disciplinary record of exchange proceedings and such additional evidence as the Commission may deem necessary and relevant.

Although Sections 8c(2) and (3) are clearly intended to authorize CFTC review of exchange disciplinary actions (to which Comex has no objections), the CFTC has never conducted a review pursuant to these provisions. Rather than perform the oversight role intended by Sections 8c(2) and (3), the CFTC has secured the contract market's investigatory files and brought its own disciplinary proceedings, thereby subjecting certain exchange respondents to dual proceedings and dual punishments.

For instance, in In the Matter of Richardson Securities, Inc., Comex's Committee on Business Conduct filed a complaint against Richardson Securities, Inc. ("RSI"), a Canadian futures commission merchant, and one of its principals, alleging violations of Comex rules on recordkeeping, margin and recording, and charging them with responsibility for the fraudulent handling of certain accounts. During the Comex proceeding, the Commission was constantly kept advised of developments. Comex found the respondents had been negligent in their supervision of their business. Pursuant to an offer of settlement, Comex therefore imposed a $32,000 fine on RSI, ordered RSI and its principal to cease and desist from further violations of the Comex By-laws and Rules, censured RSI's principal, and ordered RSI to pay its client approximately $8,000 in restitution, initiate certain compliance procedures and transfer its membership to an individual other than the censured principal. The CFTC, which had begun a proceeding against RSI and its principal at about the same time, failed to abandon its proceeding in favor of allowing the exchange to reach a decision which it could review pursuant to Section 8c(3) and immediately after the completion of the Comex proceeding, the CFTC proceeded to a trial on substantially identical issues. As a result of the CFTC's separate proceeding, the RSI principal's registration was suspended for 15 days. The respondents in Richardson therefore were forced to participate in two separate proceedings on the same general facts and at least one of the respondents was faced with two punishments for the same actions.

Beside this obvious injustice is a more subtle and dangerous consequence. Contract markets have found it increasingly difficult to secure cooperation with their investigations. Because the CFTC routinely reviews exchange investigation files and, in cases like Richardson, has full exchange cooperation on an ongoing basis throughout the exchange's own proceeding, individuals who might otherwise be willing to accept a penalty with the expectation of some return for their contrition and contribution to an investigation have become less willing to cooperate.

The institution of a separate CFTC disciplinary proceeding appears to be entirely unnecessary unless, in the Commission's judgment, the exchange's sanction is inadequate and cannot be cured by remanding. For instance, a CFTC proceeding may be necessary if the Commission believed that a respondent in an exchange proceeding 1) should be prohibited from trading on the exchange; 2) should be assessed a fine in excess of the maximum fine which can be levied by the exchange; or 3) should be prohibited from pursuing the same course of conduct on another exchange.

Accordingly, to prevent such CFTC abuses, Comex supports the Industry Proposal to amend Section 6(b) of the Act to preclude the Commission from instituting a proceeding against a person to punish a person for conduct for which he has already been the subject of punishment by a self-regulatory organization unless the Commission first finds that the punishment was inadequate in light of the seriousness of the alleged conduct.

I. Margin Authority

Exclusive authority to impose margin requirements on futures contracts currently resides in exchanges. However, under several recent proposals, margin authority for some futures contracts would be placed with the Federal Reserve Board ("FRB"). During the 96th Congress, for example, Senator Proxmire introduced S.2704 which would have granted the FRB the authority to set margins in financial instrument and precious metal futures contracts. More recently, on July 15, 1981, the General Counsel of the SEC wrote to the Chairman of the Senate Subcommittee on Securities, proposing that the FRB be provided with the authority to set margins for options on exempt securities, and for financial instrument and stock index futures. Comex opposes such proposals and strongly urges Congress to leave margin authority with the exchanges.

The common reasons given for shifting margin authority away from the exchanges curiously have nothing to do with the performance of contract markets to date. Instead, the purported justification has been one of two things. The first is to control excessive speculation, an outmoded and false concept, as discussed previously. Alternatively, authors of these proposals have urged that they are necessary to equalize margins on futures and related investment vehicles. For instance, in a hearing before the Senate Subcommittee on Securities, the General Counsel to the SEC asserted that an investor sees options on financial instruments (that are subject to FRB margin requirements) and futures on financial instruments (which are not) as "fungible" but "the two players in the field seem to be playing at a disadvantage one to the other because of regulatory requirements that are applied by the federal government". Needless to say, this type of justification suggests that the FRB may not be the best regulator for such options and not that something is wrong with current futures margin levels.

The proposals to shift authority over futures margins away from the exchanges also ignore the economic purposes of futures exchanges and the effect of margin levels on achieving those purposes. The economic purpose of and justification for commodity futures trading is to shift the risks of adverse commodity price moves from those who do not want to bear such risks (hedgers) to those who are willing to bear these risks (speculators). Because the risk of adverse price changes impose costs of doing business on the trade, an efficient price-risk shifting system benefits the entire economy by ultimately lowering costs all the way down the production line to the consumer.

While futures trading is not the only way in which price risks can be shifted -- other methods include forward contracts and inventory adjustments -- efficient futures markets offer two key advantages over these alternatives. First, futures markets are more liquid, thereby eliminating the high transaction costs on less liquid markets which arise from wide bid-ask spreads or the inability to absorb large orders without significant price moves. Accordingly, margins must be set so that the liquidity of the market is not impaired.

Second, futures markets have a greater ability than forward markets to limit the risk of default by one of the parties. In the forward market, the difference between the forward contract price and the market price is typically not paid until the maturity date of the contract. Consequently, large price movements can and do call into question the financial ability of one of the parties to the contract to perform at maturity. In contrast, futures markets provide a higher degree of security against the risk of default by imposing original margin requirements at a value equal to or greater than expected daily price fluctuations and by daily marking-to-market futures contracts in an amount equal to the day's changes in the futures market price. As a result, instead of a four or twelve month forward contract market risk, the risk on a futures contract is reduced to the value of a day's price fluctuation.

With this background, it is evident why futures exchanges endeavor to set margins which are neither too high nor too low. If margins are set too high, hedgers and speculators will be less able to obtain the capital necessary to maintain positions and therefore less able to transfer price risks efficiently. If, however, margins are set too low, the increased risk of default will make the futures markets less attractive to hedgers using the market to reduce price risks.

Needless to say, setting margin levels is a very delicate operation which is best left where there is the most expertise -- i.e., with exchanges. Even the Commission has recently acknowledged that exchanges are in the best position to determine the appropriate margin levels on futures. As explanation for its current proposal to require gross margining of omnibus accounts carried by one futures commission merchant for another, the Commission concedes that this measure is necessary to compensate for the information which is routinely obtained by the exchanges but is unavailable to the Commission and other regulatory bodies. Sources which the Commission claims it lacks are pay and collect information and the "informal informational network" which exists among member futures commission merchants of exchanges. As further evidence of the effectiveness of futures exchanges in establishing margins, it should be noted that there has never been an incident of brokerage firm failure resulting from commodity defaults.

In contrast, the FRB lacks the expertise to make the right decision at the right time concerning futures margin adjustments. Granted, the FRB has margin authority over securities. However, there are dramatic differences between margin on securities and on futures contracts. In the securities industry, margin involves a loan. There is an extension of credit from the broker to the purchaser of a security to fund part of its purchase price. Because there is a loan, interest is charged on the balance due. Ownership of the stock certificate passes immediately. In short, the margin is clearly a down payment in a credit transaction.

However, in the futures industry, margin is a performance bond. Margin deposits are earnest money -- i.e., a good faith deposit. There is no transfer of title of the underlying commodity, and no credit involvement in the purchase or sale. Because there is no loan, no interest is charged. Because futures contracts call for settlement of the transaction at some date in the future, there is no need to collect or pay at the date the futures contract is initially bought or sold. Margins in commodity futures simply guarantee that the trader will make good on his contractual commitment. Thus no credit is ever extended when a futures contract is purchased or sold, and no possible impact on the amount of credit in the economy occurs. Credit increases occur only to the extent that lending institutions are willing to finance deliveries under the contracts and possession of the physical commodities.

In the futures industry, regular review of futures markets and a constant awareness of economic factors in the market is essential to setting margin levels, especially in a volatile market. Given the massive amounts of data which must be reviewed daily to set margins properly, and the difference in function between securities and commodities margins, it is ludicrous to assume that the FRB could develop the necessary expertise to set futures contract margins properly without totally unjustifiable expenditures of taxpayers' funds. Moreover, the combination of setting improper margins and governmental costs could lead to higher trading costs, higher consumer costs, a consequent lowering of export sales, an increase in the demand for credit and the anti-competitive effects resulting from the migration of business from smaller traders to the largest and best capitalized companies.

Accordingly, Comex urges Congress to examine carefully the cost/benefit justification for any proposal to shift margin authority over futures contracts from the experts -- the exchanges -- to amateurs such as the FRB. Such measures could only lead to drastically increased costs and disastrous effects on futures markets.

J. User Fees Threaten Unnecessary Regulatory Costs

At the request of the Office of Management and Budget ("OMB"), the CFTC has submitted to Congress a proposal to authorize the imposition of "user fees" on commodities transactions. As proposed, members of contract markets or of a registered futures association such as the National Futures Association, would pay a fee of $.06 per futures contract or exchange option; all other market participants would pay a fee of $.12. In addition, a fee of $3.00 would be assessed on each dealer option granted and leverage contract entered into. Comex believes it is irrational to impose the cost of an industry vital to the entire United States economy on the relatively few persons who are market users. Comex also views this proposal as a direct threat to (1) market liquidity; (2) the viability of the recently-formed National Futures Association ("NFA"); (3) the effort being made by the NFA to decrease, rather than increase, regulatory costs; and (4) President Reagan's goal, as stated in his State of the Union Message, to balance the budget by encouraging private investment and discouraging government spending.

The OMB's stated justification for user fees on commodities transactions is that the regulation of the markets by the Commission is a government-subsidized service to the market participants: "By providing direct benefits to one type of business (or group of individuals) at no cost, the government is in effect putting competing businesses at a disadvantage. Such a distortion leads to an over-allocation of resources to the subsidized business and an under-allocation of resources to the non-subsidized business". Hence, the imposition of user fees "can lead to increased economic efficiency". OMB has also stated that "[r]ecovery of the cost of CFTC regulation . . . through transaction fees and licenses transfers the regulatory cost from the general taxpayer to the identifiable beneficiaries".

Clearly, OMB misunderstands the purpose of the regulation of the commodities markets. The Commission was not created to provide a service to market participants. Rather, Congress created the Commission because "[t]ransactions in commodities involving the sale thereof for future delivery are affected with a national public interest".

Moreover, government regulation of futures markets is not a "service" rendered for a small definitive segment of our society, like the Coast Guard services rendered to yachtsmen. It is an economic regulatory activity undertaken by the Federal government for the benefit of the nation as a whole. The commodity futures markets perform an essential role in the country's economy by providing an efficient and cost-effective mechanism through which agri-businessmen, processors of raw material, manufacturers and, in the last six years, mortgage banks, bankers and treasurers of the nation's corporations can reduce the risks associated with carrying inventories and forward pricing of products, and reduce the substantial financial risk relating to volatile interest rates. Consequently, the "identifiable beneficiaries" of the Commission's regulations are the general taxpayers and not, as OMB would have it, the small class of market participants.

In this regard, it should be noted that revenue which would result from the imposition of the proposed fees would be deposited in the miscellaneous revenues of the United States Treasury and would not be earmarked specifically for the purpose of funding the Commission. A reduction in the federal deficit is a goal which all Americans should support. However, a particular class of individuals should not be required to pay a special tax for this purpose, especially when the tax imposed is not on a luxury such as cigarettes, but on an activity which Congress has determined serves a vital function in the nation's economy and which benefits the general public rather than that particular class. Comex believes that the responsibility of balancing the federal budget should be shared by all.

Nor is the OMB justified in stating that the failure to impose user fees puts competing businesses at a disadvantage and leads to an over-allocation of resources to the subsidized business. The only competition in the commodities markets is the competition among the markets themselves. No other businesses, except those which also are subject to the jurisdiction of the Commission, may be said to compete with futures markets.

Moreover, the CFTC's "user fee" proposal totally ignores the enormous risk of decreased market liquidity which may occur as a result of imposing such fees. Particularly in light of the tremendous financial effects which were visited upon the futures industry by the hastily conceived 1981 tax legislation, this danger appears to be a serious one. Comex, in particular, is concerned about the loss of market liquidity which will result as foreign traders find the costs of participating in United States markets too exorbitant. Even now, the transaction costs of trading on some foreign markets are less than the costs of trading on domestic exchanges but our markets are favored for their efficiency. User fees may just place the costs of trading on our markets over the brink.

The danger of user fees to the viability of the NFA is also very real. As noted previously, the participants in the futures markets already bear a significant share of the burden of regulating those markets. Like their counterparts in the securities industry, all Commission registrants pay registration and other fees which reimburse the Commission for the direct costs of regulating those market participants. Moreover, all market participants pay exchange transaction fees which support the self-regulatory functions of the exchanges. Annual membership dues paid by exchange members also support those functions.

In addition to these responsibilities, market participants soon will be required to pay a second transaction fee to support the self-regulatory functions of the recently-authorized NFA. It has been suggested that the NFA, if used as it was intended when the provision for a registered futures association was originally placed in the Act, will reduce Commission budgetary needs. To impose a third transaction, or "user", fee, simultaneously with the NFA transaction fee, may effectively kill the self-regulatory body before it has been given a chance to work. In short, the CFTC's proposal is, at the least, premature.

Moreover, the concept of self-regulation represented by NFA is consistent with the Reagan administration policy to shift the regulatory burden from government to industry. As President Reagan stated in his recent State of the Union message:

> Raising taxes won't balance the budget. It will encourage more government spending and less private investment.

The NFA alternative to user fees is a responsible example of the futures industry's willingness to help pay for the cost of regulation, but in the most efficient manner possible.

In light of the significant risks of adverse effects on the futures industry which are posed by the user fee proposal, Comex recommends that Congress appoint a panel to study carefully the extent of the consequences which the imposition of user fees may incur. The Commission, in fact, has recommended that an Advisory Committee be established to study the effects of user fees on markets, but it appears that this study may be conducted after the fact rather than prior to imposition of the fees. Comex would more than willingly contribute to the cost of funding such a panel because of its belief that precipitous action on the user fee issue, in particular, could spell virtual disaster for the viability of United States futures markets.

K. Conclusion

In concluding, Mr. Chairman, I would like to emphasize that the reauthorization process should not be viewed as a time to completely restructure the regulatory environment of the futures industry. This is not what was intended by the "sunset" clause in the Act. In making any changes to the regulatory structure, particularly at this juncture in our political history, I believe we should heed the Administration's precepts. Industry, and therefore society, have only a limited amount of money to spend on regulation. Therefore, cost-benefit analyses become critical and regulators not only must find the least costly approach but must issue regulations which promise to achieve the greatest benefits and avoid regulations which would have an immaterial impact.

Reauthorization should be placed in its proper perspective. This review process should reauthorize the CFTC and fine-tune the Commodity Exchange Act -- it should not redesign the regulatory scheme leaving the industry in a shambles in its wake.

COMMODITY EXCHANGE, INC.
FOUR WORLD TRADE CENTER
NEW YORK, NY 10048

April 29, 1982

Honorable Jesse Helms
Chairman
United States Senate
Committee on Agriculture, Nutrition
and Forestry
Washington, D.C. 20510

Dear Chairman Helms:

I refer to your letter of March 23, 1982 requesting information from Commodity Exchange, Inc. ("Comex" or "Exchange") about steps taken by Comex, both during and after the silver situation, to guard against conflicts of interest, or the potential for conflicts of interest, on the part of Comex's governing board and its management committees. Specifically, you have related your question to situations involving decisions to suspend trading, order "liquidation only" trading, and take other types of market action.

Comex, cognizant of its obligations to the public to avoid even the potential for conflicts of interest, has generally attempted to insulate the decision-making process in matters relating to market action in four different ways: (1) by delegating to independent committees the responsibility for taking market action; (2) by attempting to eliminate subjective factors from certain decision-making processes through the use of objective criteria such as formulae; (3) by continually advising the Board of the subject of conflicts of interest to keep them alert to the potential for conflicts of interest and by seeking voluntary disqualification of potentially interested directors; and (4) by continually studying and evaluating the subject of conflicts of interest in an attempt to constantly seek improved methods of insuring elimination of the potential for conflicts of interest. I will explore each of these approaches both during the period from July 1979 to March 1980 and the period subsequent thereto.

1. Use of Independent Committees -- On October 4, 1979, the Board of Governors of Comex created the Special Silver Committee. Outside counsel was instructed to, and did, privately interview each prospective member of the Special Silver Committee to insure that none of them had any pecuniary interest in the silver market, either directly or through their employers. Ultimately, four members of the Comex Board were approved to serve on that committee. The Chairman of the committee was a public member of the Board. During the ensuing three months, that committee met formally eleven times, engaged in numerous telephone meetings, conducted investigations into the silver market, interviewed and conducted negotiations with large participants in the silver market and took various types of action.

The Control Committee of Comex is another example of an independent committee of Comex, both during and after the silver situation. That committee is charged with the responsibility of surveilling all of the Comex markets to insure that they are functioning in an orderly fashion and that there is no potential for market disruption. The committee is chaired by a public member of the Board. During the silver situation, the committee, sometimes working in tandem with the Special Silver Committee, continued its surveillance of the silver market.

The Comex Committee on Quotations was restructured after the silver situation to further avoid any potential for conflicts of interest. That committee is charged with the responsibility of establishing settlement prices for the various commodities traded on Comex. We have submitted to the Commodity Futures Trading Commission a new rule that would create subcommittees of that committee. No floor member who trades in a particular commodity would be permitted to serve on the quotations subcommittee for that commodity. In that way, settlement prices will be established by persons who do not trade the commodity for which the prices are being established.

2. Elimination of Subjective Factors from the Decision-Making Process -- Absent the ability to apply subjective judgments to issues relating to market conditions, it is clear that the potential for conflicts of interest cannot exist. With that in mind, Comex has taken a number of steps to adopt certain objective rules and formulae and thus avoid the potential for conflicts.

During November 1979, the Board of Comex appointed a Special Margin Committee which was charged with the responsibility of attempting to develop a formula approach to the subject of setting levels of margin. The first step taken by that committee was to adopt a tiered approach to setting margin levels which, for the first time, took into account, by use of a forumla, the "blockage" factor (i.e., the larger the position, the more potential for volatility in the ultimate liquidation of that position). Subsequent to the silver situation, the Board approved a formula for the establishment of margin based upon liquidity and volatility which, to a great extent, has removed the need for considering any subjective factors in establishing margin levels.

3. Advice to the Board -- During the silver situation the Board was regularly advised by counsel of its obligation to insure that no member of the Board would participate in decision-making on any matter where that Board member might have a potential for a conflict of interest. Any time that the Comex Board discusses the possibility of taking market action, the Board is advised by counsel on the subject of conflicts of interest. Moreover, on many occasions during the silver situation some members of the Board disqualified themselves from participating in, or voting on, prospective market action. This self-policing technique has generally been found to be an extremely effective method of avoiding the potential for conflicts of interest.

4. Continual Study of Conflicts of Interest -- During 1981, the Comex Board requested counsel to prepare a memorandum describing possible rules that the Board might consider to further avoid any potential for conflicts of interest. Subsequent thereto, such a memorandum was submitted to the Comex Board which, after extensive exploration, referred the matter to the Comex Executive Committee for further deliberations and recommendations. We expect that as a result of the consideration of this action by the Executive Committee, Comex will consider the possible adoption of additional rules relating to matters such as disclosure of market positions when market action is considered by the Board.

If you have any further questions or require any further information, please do not hesitate to contact me.

Respectfully yours,

Lee H. Berendt

Lee H. Berendt
Executive Vice Chairman

STATEMENT OF ROBERT K. WILMOUTH
PRESIDENT AND CHIEF EXECUTIVE OFFICER
BOARD OF TRADE OF THE CITY OF CHICAGO

BEFORE THE
SUBCOMMITTEE ON AGRICULTURAL RESEARCH
AND GENERAL LEGISLATION
SENATE COMMITTEE ON AGRICULTURE,
NUTRITION AND FORESTRY

March 1, 1982

I am Robert Wilmouth, President and Chief Executive Officer of the Chicago Board of Trade, the Nation's oldest and largest commodity exchange. We greatly appreciate the opportunity to appear before you today in connection with your hearings on CFTC reauthorization. I must tell you at the outset, however -- and I say this with regret -- that the Board of Trade is alarmed and disappointed with the direction taken by the CFTC regarding its reauthorization.

We are disturbed by the CFTC's lengthy and far-reaching legislative proposals -- which call for bigger, not smaller, government; and more, not less, Federal regulation. Our dismay is heightened by the fact that the CFTC makes these proposals at a time when the National Futures Association is coming on stream and our industry is about to undertake a massive and expensive additional self-regulatory burden; at a time when there is severe pressure on the Federal budget; and at a time when our political leaders are attempting to reduce regulatory interference and inefficiency.

Much of what I have to say today will be critical of the CFTC proposals -- but I am also prepared to offer some constructive suggestions which would go a long way toward streamlining the CFTC and its regulatory process and would be consistent with the positions expressed by this Administration and this Congress in favor of industry self-regulation with the minimum necessary government oversight.

There are four principal subjects which must be considered during these hearings. The first two, which are related, are the proposal for transaction taxes to be imposed on the futures markets and those who use them, and the proposals for increased regulatory authority, requiring increased manpower, submitted by the CFTC. The third subject involves the agreement between the CFTC and the SEC to divide jurisdiction over the markets for futures-related risk-shifting instruments. And the fourth subject is the package of industry legislative recommendations, now supplemented by the National Futures Association.

A "Futures Trading Regulatory Improvements Act"

Approximately one year ago a group of people representing a broad segment of the futures industry met to consider what positions they might take on the various issues that were likely to arise during these "Sunset" hearings. This group also considered the effect that a fully-formed and functioning Title III organization --the NFA -- might have on the CFTC's regulatory activities and budget. The group circulated throughout the industry a variety of position papers and legislative proposals and received extensive comment on this material. Much of the material was also given to the CFTC, although no specific attempt was made to obtain its comments and none were offered by it.

After much time and effort this group distilled its work into several quite modest proposals which have been submitted to you as recommendations for a "Futures Trading Regulatory Improvements Act of 1982." This submission contains eight proposals, with detailed supporting analysis, for amendments to the Commodity Exchange Act -- all of which are consistent with Congress' intent in 1974 when it created the CFTC and in 1978 when the CFTC was reauthorized for the first time.

The Board of Trade strongly supports these recommendations, as well as the additional and complementary recommendations of NFA (particularly its recommendation that regulatory efficiency and economy be made important policy goals of the Commodity Exchange Act). I would like to emphasize a few of them today in the brief time allotted.

CFTC Emergency Powers

The Chicago Board of Trade believes that it is critical that Congress expressly provide for judicial review of CFTC "emergency" determinations and of the remedial actions prescribed by the CFTC. The emergency provisions in Section 8a(9) of the Commodity Exchange Act, which allow the Commission to take emergency action only when the market is prevented from "accurately reflecting the forces of supply and demand," were carefully drawn by Congress in 1974. In fact, this precise limitation on the CFTC's ability to take emergency action was adopted in conference in 1974 to reconcile the conflicting provisions passed by the House and Senate.

The conferees -- and the Congress -- did not authorize the CFTC to take emergency action whenever it wished, but only when this test is met. The only way to insure that CFTC emergency actions are lawful and in accord with this standard is to make these actions judicially reviewable. The CFTC's opposition to judicial review of its own emergency actions indicates that the CFTC believes itself to be above the law and represents an unfortunate example of governmental arrogance.

Judicial review here would not mean that the courts would substitute their judgment for the CFTC. As you know, agency decisions in such areas are accorded great deference by the courts and would be overturned only if arbitrary or capricious. Still, the possibility of judicial review would insure that the Commission will use care whenever it considers emergency action such as closing the markets or suspending trading.

The CFTC opposes judicial review on the ground that it would inconvenience the agency to prepare for litigation at the same time that it is considering emergency action. We submit there will be no such inconvenience and that, even if there were, mere inconvenience should not deny us the important protection of judicial review.

Before it takes any emergency action, the Commission will have to review with great care the data available to it and the opinions of its market surveillance personnel. It is precisely those data and opinions that the Commission would offer in court to justify the reasonableness of any actions it took. When potential consequences of CFTC emergency action are as vast as they are, we think the Commission should, in all cases, be willing to submit its reasoning for review under the "arbitrary and capricious" standard that applies to agency action of far less devastating potential.

Rule Approvals

Another area in which we have suggested improvements is Section 5a(12) of the Act, which relates to CFTC approval of exchange rules. This section gives the Commission prior approval power over exchange rules relating to "terms and conditions in futures contracts" or "other trading requirements." The Commission's rule approval process has caused more day-to-day friction with the commodity exchanges than anything else the CFTC does. The approval of exchange rule changes has, in the past, taken months and sometimes years. The Commission's staff has often refused to process rules that were perfectly consistent with the Act and CFTC regulations when staff thought some other rule would be "better."

The CFTC staff has also adopted so expansive a reading of the term "trading requirements" that it even includes exchange rules relating to decorum and attire within the 5a(12) approval process -- on the ground that a requirement for a jacket and tie on the trading floor constitutes a trading requirement. In recent litigation involving the application of this Section, the Commission took the position that it has "all pervasive ... authority" over "exchange decisions ... including day-to-day decisions." Obviously, Congress never intended this to be the case. Thus, we recommend changes to Section 5a(12) which would clearly limit the Commission's rule approval authority to matters of legitimate regulatory concern and that would provide reasonable bench marks for processing rules.

It is ironic, however, that the Commission itself has suggested an amendment to Section 5a(12) that would remove any restrictions on the types of rules subject to its prior approval authority. In 1974 the now current chairman of the CFTC wrote an article discussing the Commodity Futures Trading Commission Act of 1974. The title of the article was "The Commodity Futures Trading Commission: Newest Member of Each Exchange's Management Team." With its proposed amendments to Section 5a(12), the CFTC is seeking the power to become the chief executive officer of each exchange -- not merely a member of the team.

Contract Designation

Another area in which we recommend legislative changes relates to the designation of new futures contracts. Again, this is an area which has been characterized in the past by extreme delay and by the efforts of the Commission staff to rewrite exchange contracts as the price for Commission approval. The Commission has asserted its right to do this with an overly expansive reading of the so-called "public interest" test found in Section 5(g) of the Act. We recommend that this test be replaced by a "hedging or risk management" test.

I am sure that this suggestion will be met with the criticism that exchanges might not design the best possible contract. However, the exchanges have a tremendous economic incentive to create new contracts that are of the best possible design. Exchanges spend vast amounts of time and money in designing contracts and consulting with potential industry users. Nevertheless, most new contracts do not succeed -- for a variety of reasons obviously not predictable in advance. If private industry -- the exchanges -- is willing to risk the time and money in the venture of designing new contracts, it should be allowed the chance to be either wrong or stupid. This should not be the government's concern. The marketplace should decide -- and not some bureaucrat in Washington.

Modernizing Legislative Findings

The last point in our recommendations which I would like to emphasize this morning involves the anachronistic legislative findings contained in Section 3 of the Act. This extremely anti-speculative language was passed in 1922. The language is a congressional diatribe that had no factual basis and made no economic sense at the time. Sixty years later we have come to recognize and acknowledge the beneficial and essential role speculators play in the commodity futures markets and there is no reason to subject them to any further statutory opprobrium.

Again, the specifics of these recommendations are set forth -- with detailed supporting analysis -- in "Recommendations for a 'Futures Trading Regulatory Improvements Act of 1982.'" We urge their adoption.

The CFTC Proposal

I would like to say a few additional words about the total package submitted to you by the CFTC. Taken as a whole, this lengthy bill is a prescription for vastly increased regulatory authority by the CFTC. I have already alluded to the rule approval process. Generally, the CFTC proposals would grant it more power and more discretionary authority, and would remove sensible statutory standards and limitations on the CFTC's power over the futures industry. And, as the Commission itself seems to have recognized when it asked for a personnel increase of 100 staff years for fiscal year 1983, these proposals would also require increased Commission manpower.

The Transaction Tax

In an effort to "sell" these proposals and the greater manpower that would be required, the CFTC has also proposed to finance its future regulatory activities with a new tax. Evidently, the Commission believes that its services benefit individuals who trade futures contracts in direct relation to their volume. In economic terms, the Commission believes that its services represent an "externality" -- futures traders receive a benefit, but pay no compensation.

There are several major errors in the Commission's apparent logic. Federal transaction "fees" on the futures industry (which clearly are a tax on the industry -- there can be no doubt on this point) cannot be justified economically. The benefits of regulation are not limited to traders. In addition, the benefits are not accrued in direct proportion to the volume traded.

As we all know, and as the Commodity Exchange Act recognizes, futures markets benefit everyone. They improve the pricing efficiency in cash markets by providing a continuous pricing reference for domestic and international trade. They reduce the cost of production or inventory management by providing an efficient means of reducing price risks. As a result, costs are lower for producers and prices are lower for consumers.

The benefits of futures markets, and the benefits of regulation to improve futures markets, are widely spread. In economic terms, the benefits are public goods. The benefits to each individual or group cannot be measured and priced. Economic theory indicates that such governmental services should be financed from general tax revenues.

Even if benefits were limited to traders, it is incorrect to argue that the benefits of regulation are directly related to the volume traded by each individual. According to analysis at the Chicago Board of Trade and the Chicago Mercantile Exchange, 40 to 60 per cent of all futures trading originates on the floor of the exchange. Much of this activity is conducted by professional traders who attempt to make small profits on large numbers of transactions. Professional traders in futures markets make a market -- assume most of the hedging load -- because of the profit incentive. Obviously, the direct burden of a transaction tax would be borne largely by the professional traders. It is inconceivable why market makers should bear the major burden of financing the government regulation of futures markets.

A transaction tax, levied on the volume of trade, can be expected to have a serious and highly detrimental impact on futures markets. It surely will cause a decline in the participation by all traders -- but particularly by professional traders. As a result, liquidity in futures markets will decline. The costs of hedging and speculating will rise, not only because of the increase in the direct cost (i.e., the CFTC tax), but also because of the increase in the indirect cost (i.e., the execution costs as a result of reduced liquidity).

A CFTC tax will decrease the two major benefits of futures trading -- hedging and price discovery. Hedging effectiveness will decline as market liquidity decreases and orders to place or liquidate hedges cause larger price impacts. Ultimately, the increase in the costs of transferring risk will lead to wider marketing margins and higher commodity prices for consumers. The benefit of price discovery from futures markets will also suffer because of the reduction in market liquidity. As a result, the disseminated prices will not be as useful to members of the industry in their production and inventory management decisions.

According to economic theory, a government regulatory agency can be justified only if there is a market failure. The market failure theory states that a government regulatory agency created to prevent abusive trade practices, fraud, and deceit in futures markets -- for example the CFTC -- can be economically justified only if the following conditions are true:

(1) Abusive trade practices, fraud, and deceit would be execessive in an unregulated environment.

(2) The agency could reduce these improper practices.

> (3) The benefits of reducing these improper practices by imposing regulations would exceed the costs.

Whether these conditions hold in the futures industry has not been the subject of any academic study. My own opinion is that the futures industry has always been aware that abusive practices are damaging. In fact, the industry had been regulating itself for years before the creation of the Commission, or even its predecessor, the Commodity Exchange Authority. Because the futures industry is self-regulated -- and vigorously so -- improper practices would not be excessive in an unregulated environment.

A rigorous analysis of the SEC has been conducted, however, by Dr. Richard Zecher (a former chief economist for the SEC) and Dr. Susan Phillips (now a CFTC Commissioner). In their book The SEC and the Public Interest, they conclude that "no documentation by the SEC is available that shows that their regulatory programs have reduced the amount of price manipulation, fraud and deceit." Their overall conclusion is that:

> Contrary to the traditional view of the SEC as the New Deal's most successful regulatory agency and protector of investors, the SEC appears to be primarily concerned with maximizing support (net support) for their regulatory programs. This practice results in a net benefit to some groups and a tax on others, but more important it produces regulation insensitive to the costs of programs and to an evaluation of their effectiveness.

Thus, to the extent the CFTC mimics the SEC -- and that clearly is the thrust of the CFTC's legislative package -- the public interest is in danger.

Finally, questions arise concerning whether the benefits of CFTC regulation exceed the costs. The direct cost of CFTC operations is proposed by the Administration at $23 million for Fiscal 1983. However, the major cost of regulation is imposed on the private sector through compliance. Murray Weidenbaum estimated that "in 1976, ... the aggregate impact on the private sector of government rules and regulations was some 20 times larger than Federal expenditures for such activities that year." It is extremely doubtful that the benefits accrued from the regulations imposed and enforced by the CFTC exceed the direct cost of $23 million plus the vast indirect cost of $460 million! And this figure does not even include the substantial sums spent by the exchanges in connection with their self-regulatory programs.

The imposition of a CFTC tax would be perverse in economic terms and a dangerous and disquieting precedent for the growth of Federal economic regulation. It is the antithesis of the Administration's vow to get Government off the backs of the people.

The implications of a "user fee" to the commodities industry are well stated by CFTC Chairman Johnson in his recently published treatise Commodities Regulation:

> [T]he industry would be called upon to pay the cost of Commission programs over which it has no practical control. New, costly programs could be initiated by the Commission without concern for budgetary factors or whether they are efficient on a cost-benefit basis. Despite the fact that the industry may consider the programs to be ill-advised, unnecessary, or profligate, the Commission might require the industry to pay for them. I Johnson, Commodities Regulation 415 (1982).

In submitting its budget for fiscal year 1983, and with which its taxing scheme is inextricably intertwined, the Commission also failed to give any recognition to the vital regulatory role the National Futures Association will play in this industry, and to the cost savings the National Futures Association should bring to the Commission, and must bring if it is to be justified. NFA calculates the functions it will be performing for the Commission should result in a savings to the Commission of approximately 150 staff years, or approximately $7 million using 1982 levels. Nowhere does the Commission acknowledge this fact.

Indeed, the manpower savings made possible by NFA, taken together with the Commission's request to increase to 570 persons in fiscal year 1983, indicates that the Commission would like to effectively increase its manpower by over 250 over the next two years. There is simply no justification, outside of a desire for more government and more power, to support such a request. At a minimum, the CFTC must be directed to avoid regulatory duplication and redundancy.

We do not seek a comatose CFTC, as some have suggested. But we do believe that our proposals to limit Commission authority over the day-to-day management of exchanges, and to expedite contract market approval, would be a clear indication to the Commission that its regulatory role should be one of oversight rather than direct control of the futures industry, and a further indication that the times when "bigger" means "better" for federal agencies are gone forever.

Jurisdiction

Finally, let me say a few words about the jurisdictional amendments which have been offered to implement the Johnson-Shad agreement. We are aware of the pressures on the CFTC when this agreement was concluded. Indeed, the Board of Trade is a party to several lawsuits (in which the Commission joined us as amicus) in which we are challenging the SEC's power grab in the area of commodity options and in which we are seeking to preserve the jurisdiction granted by Congress to the CFTC in 1974 and unequivocably confirmed by Congress in 1978.

We are also aware that this jurisdictional dispute brings thorny and difficult legislative issues to Congress. Nevertheless, I would be remiss if I did not express the grave forebodings we have about the ultimate effect of this jurisdictional agreement.

The rationale for maintaining the CFTC and the SEC as two separate agencies has always been that the regulation of futures trading is the "horizontal regulation" of a function -- that is, the trading of risk-shifting instruments. Indeed, all futures contracts can be defined as financial instruments which transfer the risk of price fluctuations from one party to another. The CFTC is a specialized agency which has made great strides in understanding these kinds of markets.

The function of the SEC since its formation has been to regulate and preserve the capital-formation markets. Although it often loses sight of this ultimate objective, everything else the SEC does, from disclosure requirements to customer protection rules, is to protect the integrity of capital markets in the United States.

Exchange-traded offset options are but a form of futures trading. They are risk-shifting instruments, whether the underlying commodity is sugar, gold, foreign currencies or Treasury bonds. And as CFTC Chairman Johnson writes in his new treatise:

> Indeed, Congress has recognized that the [Commodity Futures Trading] Commission is the expert agency with respect to hedging and pricing markets. Accordingly, if jurisdiction were to be vested in the most qualified agency for the regulation of these functions, the logical choice would appear to be the Commission. II Johnson, Commodities Regulation 48-49 (1982).

The CFTC-SEC agreement proposes that the SEC be granted jurisdiction over certain of these risk-shifting instruments, and thus blurs this historic distinction between risk-shifting and capital formation functions. In our view, it lays the foundation for attempts to merge the two agencies, which we think would be very unwise because their primary regulatory focuses would still be so divergent, and would be particularly dangerous to American agriculture.

In short, we are very troubled by the jurisdictional provisions which the CFTC now asks you to enact into law. They simply cannot be defended from principle or on the basis of economic theory. And they will reward the SEC for its arrogant disregard of Congress' jurisdictional assignment first made in 1974 and confirmed in 1978. If Congress nonetheless chooses to enact this jurisdictional agreement into law, it is our hope that this Committee will continue in the future to appreciate the functional distinctions between the risk-shifting markets and the capital-formation markets and act accordingly.

In addition to this general comment, let me point to a few of the specific problems we see with the jurisdictional proposal. The CFTC's program for the trading of options on futures contracts is a very limited program in which each commodity exchange will be allowed to trade only one option for a two-year period. The SEC, however, has stated that it is prepared to license trading in options on physical commodities without any such limitation.

The CFTC to our knowledge has taken no position on proposals by the American Stock Exchange to trade options on "Bullion-Valued Promissory Notes"; and we see no distinction between these and a hypothetical "Soybean-Valued Promissory Note" or a "Crude Oil-Valued Promissory Note." Nor do we know what is encompassed by the term "foreign currency" for purposes of SEC option jurisdiction. And what colorable claim does the SEC have for being granted any jurisdiction over foreign currencies -- items which are no more securities than are pork-bellies or corn?

If the purpose of the Johnson-Shad agreement is to resolve jurisdictional disputes in the future, it would seem that these issues should be resolved before the agreement is cast into stone in the form of legislation.

Rather than allowing this Committee to study all of these issues, the CFTC appears hell-bent on a course intended to breathe life into the agreement by administrative fiat. On Monday, February 22, the CFTC published in the Federal Register a notice of a proposed rule purporting to implement the "agreement" by exempting transactions in options on exempt securities, on certificates of deposit, and on foreign currencies from the commodity options ban enacted by the Congress in 1978 in Section 4c(c) of the Commodity Exchange Act, provided that those transactons occur on a stock exchange.

In a transmittal letter to Chairman Helms dated Friday, February 19, CFTC Chairman Johnson specifically noted that, immediately after the 30-day comment period, the CFTC intends to adopt the rule, and to make it effective immediately. Clearly, the Commission now is attempting to circumvent this Committee and enact its legislative proposals administratively. Such behavior should not -- cannot -- be countenanced, and we will do everything in our power to assure that this Committee and this Congress decide what the law should be -- and not the CFTC and the SEC.

Conclusion

In conclusion, let me reiterate the tone with which I began today. Although we at the Board of Trade have had conflicts and disagreements with the CFTC, we do recognize that there is a role for the Commission to play in the regulation of futures trading. Over the last six years the CFTC commissioners and staff have achieved an increased understanding of the complexity of the futures markets. It was our hope as we approached these hearings that they would be relatively harmonious and result in some desirable "fine-tuning" of the Act. I regret that the CFTC chose a different route.

We remain confident, however, that fine-tuning will be the approach you choose to take -- that the theme of this CFTC Sunset II will be "regulatory improvements" -- and not "more business as usual" to be funded by yet another tax.

We have prepared some additional written material which I respectfully request be included in the record. I particularly urge you to review our discussion on jurisdiction. We also request the opportunity to submit our further views and comments on any of the issues which might arise in the course of these hearings.

Robert K. Wilmouth, *President*

The
Chicago
Board of
Trade

May 11, 1982

Honorable Jesse Helms
Chairman
Committee on Agriculture,
  Nutrition and Forestry
United States Senate
Washington, D.C. 20510

Dear Senator Helms:

I am pleased to respond to your inquiry regarding policies of the Board of Trade of the City of Chicago concerning the elimination and avoidance of "conflicts of interest" involving governing members of this Exchange. At the outset, I want to state unequivocally that the Board of Trade is proud of its policies and practices and continues its commitment to the maintenance of a responsible and responsive decision-making process of the highest integrity. Thus, we welcome inquiries such as yours.

There is always potential, of course, for allegations of "conflicts of interest" in connection with the self-regulatory decision-making process. There is a particularly perverse mentality which always suspects the worse of the private sector and seeks to deify bureaucratic decision-making as the only acceptable model. Upon scrutiny, however, such allegations have no foundation in fact. For example, during the July 1979 through March 1980 time period, our Business Conduct Committee and the Board of Directors were the primary governing bodies which monitored our silver futures market. The Business Conduct Committee is charged with general surveillance of the markets; the Board of Directors is the governing body authorized to take emergency action and charged with special, nondelegable duties under Section 5 of the Commodity Exchange Act. Please be assured that members of these governing boards were and are acutely aware of their obligation to render objective decisions and the ever-present potential for allegations of "conflicts of interest."

Chicago Board of Trade Rule 542.00 provides that the Business Conduct Committee may require recusal of any or all of its members if it is determined that participation during the consideration of a particular matter is improper. Further, all meetings of the Board of Directors and members' committees are governed by established practices of parliamentary law pursuant to Chicago Board of Trade Rule 130.00. It is a general rule of parliamentary law that "no one can vote on a question in which he has a direct personal or pecuniary interest."*

All hearings conducted by the Board or any committee are held before disinterested members of the hearing body; no member may participate in a hearing if "he or any person or firm with which he is affiliated has a financial, personal or other direct interest in the matter under consideration."*

Minutes of Board of Directors meetings during the silver situation demonstrate that governing members made specific inquiries to prevent "conflicts of interest" and potential allegations of such conflicts. At a Special Meeting of the Board of Directors on

---

* Robert's Rules of Order, §46 (1979).

October 18, 1979, the Board unanimously voted to delay that morning's opening of the silver market. The Chairman of the Board (whose term expired January 28, 1980), the only member of the Board of Directors who held an outright position in silver during the entire July 1979 through March 1980 time period, did not attend the meeting. One director abstained from voting. The minutes reflect that, "Prior to any discussion, the individual members of the Board were polled to determine that neither they nor the firms with which they are associated had any conflict of interest due to trading positions."

On October 25, 1979 the Business Conduct Committee met with the Board of Directors to discuss the silver market. Again, the Chairman of Board did not attend the meeting. The minutes of the meeting state that, "A poll was taken to determine the silver positions of each of the Board and Business Conduct Committee members present." The minutes detail whether each member present held silver positions and reflect that, "The Business Conduct Committee determined that no conflicts existed with respect to these positions, as they were all spread positions."** The Board of Directors voted 12-1, with one abstention, in favor of an emergency rule limiting silver positions to 600 contracts in any one month or all months combined.

Likewise, at the January 22, 1980 meeting at which the Board of Directors took emergency action and ordered liquidation-only trading in January, February and March silver conracts, all directors revealed their silver positions prior to voting. Again, the Chairman of the Board did not attend the meeting or participate in any manner.

Board of Trade policies and procedures regarding conflicts of interest with respect to silver futures trading during July 1979 through March 1980 have been vigorously scrutinized. The results of the most recent examination appear in the Rule Enforcement Review of the Board of Trade conducted by the Division of Trading and Markets of the Commodity Futures Trading Commission. The Board of Trade fully cooperated with the Division and freely provided detailed responses and position information of governing members upon request. Although the report details the silver situation at length, Commission staff found that:

> ... the Board [of Directors] had a significant amount of information before it throughout the course of the silver situation. Moreover, the Board and the relevant Committee appear to have considered that information in a thorough and deliberative manner. Accordingly, after reviewing Board and Committee minutes, staff reports and conducting interviews of the members involved, the Division believes that, in these particular situations, the Exchange's actions were founded upon a reasonable basis in fact and were not arbitrary, capricious or an abuse of discretion. The emergency actions taken by the Board appeared, at the time taken, to be logical and legitimate means of addressing the particular market problems confronted. Within the limits of its review as described above, and as discussed below regarding position information of

---

* This provision is presently found in Chicago Board of Trade Rule 540.03(b). Prior to this, the prohibition against an interested member of a disciplinary body serving on the committee during a hearing was found in essentially the same form in Rule 544.00.

** During the course of the July 1979 through March 1980 time period, some members of the Business Conduct Committee and some directors held spread positions in silver futures contracts. A spread position is one in which a person holds equal positions on both sides of the market. Such a person is essentially price neutral and cannot benefit from price movements.

> the Board, the Division is not aware of any reason to conclude that the Exchange's emergency actions were taken in bad faith. Accordingly, the Division is of the opinion that ... action taken by CBT to deal with the emergencies were appropriate to the fair and orderly functioning of the market, and thus beneficial to the general public interest.*

Ultimately, Commission staff determined that:

> ... on the basis of the information available to it, the Division has no reason to believe that any vote taken by any Board member on any issue affecting the silver market constituted bad faith or self-dealing.**

In addition to the Board of Trade's formalized rules discussed earlier, and in light of the above-described instances in which governing members specifically addressed possible charges of "conflicts of interest," there also exists at this Exchange a broad spectrum of general policies and procedures which insure sufficient safeguards against conflicts of interest or allegations thereof. These general policies were efficient and effective tools during the July 1979 through March 1980 time period and remain in full force and effect today.

* * *

I am sure you appreciate the difficulties inherent in defining those circumstances in which a true "conflict of interest" can be shown to exist. It is much easier to preface "conflicts of interest" with the word "apparent" or "potential" and subsequently address impressions or subjective feelings rather than facts. An "apparent" or "potential" conflict of interest exists whenever the observer, reacting to his own preconceptions and biases, chooses to question the motives of decision-makers. "Apparent" means that which is "manifest to the senses or mind as real or true on the basis of evidence that may or may not be factually valid" or, in short, "not actually being what it appears to be;" the term "potential" is defined as "existing in possibility" but not necessarily in fact.+ These words, in effect, address only the observer's state of mind and not the true quality of the decision-making process.

The definition and identification of genuine conflicts of interest is a far more complex task which, in our view, is the relevant undertaking warranting attention. While it is the policy of the Exchange to avoid whenever possible even the appearance of conflicts of interest, it must be understood that our efforts in this regard are to forestall false and unwarranted accusations and do not suggest in any way that a true conflict of interest may exist or even that a conflict is suspected.

Only when the term "interest" is defined can the existence of a "conflict" be determined. "Interest" can be given either a broad or narrow definition, depending upon the desired objective and the effect the definition would have upon the decision-making capability of the institution. An expansive definition imposes the greatest restraints on the decision-making process and, under certain circumstances, could actually paralyze the organization. Therefore, it is extremely important to consider the impact of the definition upon the institution's ability of function.

The Board of Trade is a self-governing, self-regulating organization operated in large measure by its members who are engaged

---

+ Webster's New Collegiate Dictionary (1981).

* Rule Enforcement Review of the Board of Trade of the City of Chicago, Commodity Futures Trading Commission Division of Trading and Markets, pp. 27-28 (April 12, 1982).

** Id. at 28.

in various business activities within the futures industry. All such members have an "interest", broadly stated, in the welfare of the industry as a whole and in the prosperity of their own businesses as well. Those members holding decision-making positions at the Exchange are, therefore, necessarily affected in some degree by all decisions reached by them. Nevertheless, both Congress and the Commission have expressed support and confidence in the exchanges' form of self-governance. Clearly, an overly broad definition of "interest" in a self-regulating organization would defeat both the purpose and effectiveness of self-governance. Self-regulatory institutions can function only if the term "interest" is more precisely defined.

One consideration in defining "interest" is the predictability of the effect of an action or decision on the members of the governing board. Frequently, it is extremely difficult to know in advance whether a particular action will benefit or harm those charged with the duty to make the decision. Review of the effect after the fact provides poor guidance in determining whether decision-makers judge the propriety of their participation in the matter.

The nature of the interest must also be reviewed. A particular decision may promise to benefit the board member directly, his family, a business associate, valued customers, social or fraternal acquaintances, or others whom the decision-maker seeks not to injure needlessly. Conversely, a particular decision may be expected to disadvantage a competitor, personal enemy or other antagonist. The benefit or detriment may be immediate or long term; it may be slight or substantial. The nature of an interest may take many forms, with many effects, over different periods of time.

A determination of whose interest is involved is required. It must be determined whether the matter involves a private decision affecting selected private individuals or a public interest; if a public interest is involved, criteria must be established to define "public." The definition of "interest" may relate only to those with a direct interest in the matter or to all who might be affected by a particular decision.

Lastly, consideration must be given to the control or influence which a board member may have over a particular decision. Government regulations require "blind trusts" to be created to avoid conflict situations for certain individuals; the presumption in such circumstances is that control and not ownership or economic benefit is paramount in determining whether a conflict exists. The same could be said to be true of any governing body. If numerous votes are required for passage of a particular proposition, the benefit to one of the participants may not be a conflict because the individual participant may not be in control of or capable of influencing the decision.

To date, no one has successfully fashioned a definition of "interest" which is appropriate in all circumstances. The only practical approach is to review each matter on a case-by-case basis. In each instance, board members must determine the immediate problem, the availability of alternative solutions, the predictable effect of each solution, whether a decision-maker could reasonably expect a benefit from the solution he favors, whether the decision would benefit a board member directly or indirectly, the type of benefit or harm which would inure to others not in the decision-making process, the audience at which the decision is directed, and whether it is likely, considering all of the circumstances -- the nature of the problem, the possible solutions, the predictability of benefit, the nature of the expected benefit, and the recipient(s) of the benefit -- that objective decision-making will not occur. These questions cannot be answered in a codified rule. A case-by-case analysis is the only meaningful approach.

It must also be recognized that even where an "interest" can be identified a judgment must be made as to its significance. A major financial interest in the outcome would, as a rule, warrant greater caution than a non-pecuniary interest. For example, a vote to close the market on the day preceding a major holiday may be motivated by the decision-maker's desire to undertake a family trip or to afford his employees an extra day of vacation. There is serious doubt that recusal is warranted in the latter situation even though the existence of a personal interest is undeniable. An indiscriminately broad definition of "conflicts of interest" could prohibit a person with any personal interest from voting. Thus, the identification of an "interest" is simply the beginning, not the end, of the conflicts inquiry.

The significance of an "interest" may depend ultimately not upon whether the decision-maker or related persons may benefit, but whether others may be harmed. Participation in a decision which may have a predictable market impact (assuming that such is reliably predictable), so as to generate significant economic benefit for the decision-maker or significant detriment to other market participants, is a type of "conflict of interest" to be avoided. Accordingly, it is appropriate to review not only whether a benefit can be expected to inure to the decision-maker but also whether others will suffer a detriment.

As noted earlier, it is frequently impossible to know whether a particular action will have a market impact and, if so, what that impact may be. Moreover, viewing the market as a whole, each market movement is "neutral," that is, each movement benefits one-half of the open positions while adversely affecting the other half. Thus, it cannot be presumed in these circumstances that the decision-maker necessarily favors a particular market impact. The nature of futures markets as having a "zero sum" outcome serves as a check against biased decision-making by those whose business interests span both sides of the market. For that reason, a mechanical calculation of the "net" position of the decision-maker's firm, partners or customers provides very little evidence from which to conclude that his actions will not be objectively determined.

The personal or family interests of a decision-maker are a somewhat more useful indicator that objectivity may be impaired; but even when examining this data, hasty conclusions must be avoided. One must further consider the significance of the decision-maker's interest, how confidently the market impact of his decision can be predicted, and the existence of other factors -- dedication to duty and the likely effect of his action on others -- which may override his interest in furthering personal advantage. One must also evaluate those steps outside of the decision-making process which are available to a board member to protect his interests in the face of a problem which he may be called upon to resolve. For example, a decision-maker may exit the market or assume a "spread" position in order to neutralize any personal interest which he may have. Before concluding that a conflict of interest exists, there must be evidence that the decision-maker will subordinate his duty to personal gain or protection.

A presumption of integrity must exist in every decision-making process, including that of a self-regulatory organization. The courts have consistently upheld the actions of this Exchange in the absence of firm proof that such actions were taken fraudulently and in bad faith;* and never has such proof been given. This presumption is essential to the efficient performance of the exchanges' role under the Commodity Exchange Act. The burden must be on the challenger to overcome that presumption, not with inflammatory accusations or groundless supposition, but with hard proof that a decision was governed by bad faith and self-interest. Again, it is a compelling fact that throughout its long history the integrity of the decision-making process of the Board of Trade has never been successfully challenged despite the combined benefits of hind-sight and exhaustive discovery.

---

* Daniel v. Board of Trade of the City of Chicago, 164 F.2d 815 (7th Cir. 1947); Lagorio v. Board of Trade of the City of Chicago, 529 F.2d 1290 (7th Cir. 1976). Cf., Cargill, Inc. v. Board of Trade of the City of Chicago, 164 F.2d 820 (7th Cir. 1947).

I do not suggest, of course, that genuine conflicts of interest cannot occur. The possibility exists that a person, pledged to protect the welfare of others, will subordinate that duty to personal advantage. It is not a risk unique to the futures industry or to self-regulating organizations. However, it is vital to recognize the basic fact that the phrase "conflict of interest" has not been (and perhaps cannot be) given a precise definition in any segment of society, government or industry. The carelessness with which the phrase is invoked bespeaks its imprecision; and even then, the inaccuracy of the phrase is usually heightened by modifiers such as "apparent" or "potential."

Thus, the Board of Trade does not have an official definition of "conflicts of interest." Indeed, we are not aware of the existence of any such definition of operational utility. Members of governing boards eliminate and guard against true conflicts by careful examination of the following facts on a case-by-case basis; this analytical approach serves to identify the presence of genuine conflicts of interest and assures objective decision-making:

(1) The nature of the problem or action to be considered;

(2) The nature and availability of alternative solutions;

(3) The predictability of the impact of each solution upon persons to whom the solution would apply;

(4) The nature, significance and duration of the impact, if reliably predictable;

(5) The type of "interest" possessed by the prospective decision-maker, whether financial, non-pecuniary, social, direct, remote, significant or _di minimus_;

(6) The ability of the prospective decision-maker, in the case of an "interest" which is sufficiently direct and significant, to take steps to neutralize or eliminate potential advantage;

(7) The likelihood that retention of that "interest" would impair objective decision-making;

(8) The audience to be affected by the decision; and

(9) A members's control or influence over the decision-making process.

Additionally, each decision-maker at the Board of Trade is informed, upon assuming office, of his right to be recused from any debate, decision or action even in the absence of a conflict of interest if, in his opinion, participation may evoke criticism from any source, however uninformed, of his role in the decision-making process. This system of self-recusal is frequently invoked even though the circumstances fall far short of creating a duty to do so.

The Board of Trade pioneered the use of public directors on its Board of Directors. The Exchange has enjoyed notable success in attracting eminent individuals to serve as non-industry representatives. Our three public directors make a major contribution to the decision-making process of this Exchange. However, they do not profess to be conversant in the futures markets and, in problem-solving matters, they must necessarily rely heavily on Board members who are knowledgeable and experienced in the markets. Thus, a self-regulatory Exchange gains from the participation of its public directors but, at the same time, needs the expertise that only industry professionals can provide.

For the most part, the governing board of the Board of Trade is elected by the full membership comprised of every possible form of business enterprise in the futures industry and representative of every conceivable type of interest. Directors are nominated and elected for the purpose of serving the institution and the public. The election process itself serves to screen out those individuals who do not enjoy the respect and confidence of the majority of voting members.

Committee appointments are likewise made with the institution's best interests in mind. Neither the Chairman nor the Board of Directors would appoint to any committee an individual whose dedication to the institution's duties is open to legitimate question; appointments would be resisted and challenged by the membership. Moreover, integrity is a threshold requirement for membership in the Board of Trade pursuant to Rule 200.00. For 134 years this Exchange has carried out its duties without a single judicial finding of a conflict of interest -- even after full and dispassionate review of its actions. This record speaks for itself and warrants not only the legal presumption of legitimacy but also factual confidence in the integrity of Exchange procedures.

All decision-makers at this Exchange are cognizant of their duty to perform their functions in an objective manner. As already indicated, directors and committee members frequently abstain from participation in decisions which may be perceived as affecting their interests. Ordinarily, such a person will retire from the proceeding entirely. However, when the presence of that person is necessary in order for participating decision-makers to have access to all pertinent facts, the governing body may permit attendance for the strictly limited purpose of providing that information, but prohibit participation in the discussion, debate or vote on the matter under consideration. From time to time, and as illustrated earlier, the procedures of a particular meeting have included each member openly disclosing his interest in the subject matter with respect to which action will be considered. Since this procedure is a serious compromise of the decision-makers' right to confidentiality, as reflected in Section 8 of the Commodity Exchange Act, it is not utilized routinely or indiscriminately.

The President of the Board of Trade -- a non-trading professional executive -- is an ex-officio member of both the Board of Directors and the Business Conduct Committee. Directly under his supervision is the Exchange's Office of Investigations and Audits, the repository of confidential data regarding open positions of market participants, including decision-makers. As needed to assure the integrity of the decison-making process, the President reviews such data and, in appropriate cases, confers with individual decision-makers regarding their intended role in a matter to be considered for action. Legal counsel is present at all Board, Business Conduct and Executive Committee meetings to advise participants as to their rights regarding any "conflict of interest."

Critics of a particular action are frequently those who stand to gain from undermining public confidence in the decision-making process. It must also be recognized that suspicion is high among those who doubt the efficacy of self-regulation in general, and who trust governmental domination in particular. In a very real sense, self-regulation as a governing concept is put on trial whenever it is presumed that self-interest is necessarily present in the decision-making process and that self-interest is necessarily the prevailing motivation whenever it is present. If the objective were to extinguish each and every "apparent" or "potential" (as distinguished from real) conflict of interest, governance would have to be vested in persons having absolutely no interest in what is done; that is, self-regulation would have to be abandoned in favor of third-party control. To date, neither Congress nor the Commission has committed itself to that concept. Instead, the multitude of benefits gained from the expertise and dedication of industry participants far outweigh any alleged benefit the public could derive from dismantling self-regulation in favor of total external bureaucratic control.

The Board of Trade assures you that it takes seriously the responsibility to render objective decisions. It must be remembered that this Exchange is the world's largest, with a "constituency" which includes agribusiness, finance, construction and other interests both here and abroad. Such interests are forever in conflict with one another, as in any competitive environment; they would not, and could not, tolerate the ascendancy to dominance of any single interest at this Exchange. Even a suspicion that objectivity is impaired would cause these diverse participants to look elsewhere for services. Yet, the opposite has occurred; this Exchange has experienced phenomenal growth and a dramatic increase in both the numbers and types of its users.

Presently, and during the July 1979 through March 1980 time period, sufficient safeguards were and are implemented at the Board of Trade to insure that those charged with decision-making authority do not and cannot profit from their decisions. To the extent that genuine conflicts of interests are capable of occurring, efficient and effective measures were invoked during the silver situation and continue to be utilized at this Exchange to prevent them.

Very truly yours,

Robert K Wilmouth

Robert K. Wilmouth

STATEMENT OF

DR. CLAYTON K. YEUTTER

PRESIDENT, CHICAGO MERCANTILE EXCHANGE
BEFORE THE
SENATE AGRICULTURE SUBCOMMITTEE
ON AGRICULTURAL RESEARCH AND
GENERAL LEGISLATION (NO. 4)

MARCH 1, 1982

Mr. Chairman and members of the Subcommittee, my name is Clayton K. Yeutter. I am appearing today on behalf of the Chicago Mercantile Exchange of which I am President. The Chicago Mercantile Exchange is one of 11 futures exchanges currently operating pursuant to CFTC designation. One of our divisions, the International Monetary Market, pioneered financial futures and, with dedication and at enormous cost, demonstrated that the market was ready for such contracts. Financial futures have been the success story of the past decade, and a boon to commercial interests that wish to lessen the degree to which their fortunes depend on otherwise uncontrollable fluctuations in the value of foreign currencies or interest rates. The success of these markets means that the last great speculators are businesses without access to[*/] or without the knowledge to intelligently use futures markets.

While the formal issue before your committee is whether the CFTC ought to be funded and the length of time for which such funding ought to be authorized, sunset hearings have traditionally become a forum for the airing of

---

[*/] For example, some states absolutely and foolishly bar insurance companies subject to their jurisdiction from the use of futures markets.

complaints about the behavior of an agency and the structure of its governing statute. Consequently, a large segment of the industry met well in advance of these hearings in order to avoid a grand scale attack on the Commission and major revision of the Act, and to settle on the minimum necessary changes that would do the least violence to a statute that has worked well and allowed the growth of a very important industry.

Our fourteen page proposal, which takes the form of the Futures Trading Regulatory Improvements Act of 1982, has two major purposes. First, we seek to reaffirm the original intent of certain sections of the Act where that intent has been systematically ignored by the CFTC in connection with its regulation of the industry, and where, for technical or other reasons, we have been unable to secure judicial review which would tend to correct the agency's abuses. Second, we have taken the liberty of modernizing certain of the legislative findings which were incorporated in the Act in 1922 (and reiterated in 1936) in order to overcome a Supreme Court holding that Congress did not have authority to pass the Act. Those findings were not based on any actual study, are incorrect, have long since served their purpose and are now a source of mischief.

The CFTC's approach to the reauthorization process is excessive (42 pages) and constitutes a reversal of the legislative philosophy of the Act. The CFTC has, of course, sought to justify its improper interpretation of the law by proposing legislative changes which will sanction its administrative excesses.

But that is the least startling part of the CFTC's package. The CFTC has interpreted the President's proposals for deregulation to mean deregulation of the agency rather than of the industry. Again and again, the Commission has proposed changes which unfetter its discretion, eliminate formal hearings, and reduce the efficacy of or eliminate judicial review. The Commission assures us, and assures this Committee, that it is composed of rational, well-meaning men who will not abuse that freedom. While it is true that the Commission's recent performance bears out its promise of rationality and responsiveness, there is nothing in our system of government that suggests that the destiny of an industry should depend on the continued goodwill and wise conduct of appointed, long-term Commissioners rather than on a body of law which will adequately control the regulatory process and afford to those who are being regulated due process.

A brief review of our major proposals affecting exchanges, as contrasted with the corresponding Commission proposals, will bear out this analysis.

Contract Market Designation - Sections 5(g), 6

The industry proposal is intended to embody the universally accepted philosophy that the marketplace should be allowed to decide whether a contract proposed by an exchange is useful and beneficial so long as that contract is not in violation of any provision of the Act or valid Regulation promulgated thereunder. This philosophy is now accepted by the Commission, and is currently governing their designation procedures. However, that has not always been the case. Therefore, we should not be required to rely on the "personality" of the Commission to assure that this doctrine continues.

A bureaucracy which has the power to delay action has the power to cause a contract market to modify a new contract submission in order to accord with the Commission or staff's view of what is best for the marketplace, the submitting exchange, or the general public. For many years we and every other contract market operated under such a regime. The staff, which was without hands-on experience in the operation of a contract market or the trading of commodities, forced the substitution of contract provisions in order to satisfy its concept of what would be "in the public interest." Exchanges were forced to accept arbitrary and often incorrect staff fiats in order to get their submissions before the Commission for action: If the staff was not satisfied, it would simply hold the contract for further review until such time as the contract either became stale or a competing exchange, more willing to capitulate to the staff's requests, had their contract approved and commenced trading. While judicial review of the failure of the Commission to act is available, that process has not proved to be an adequate remedy.

The industry bill substitutes for the current designation test, which is that a contract "will not be contrary to the public interest," a specific standard that can be tested, namely, that the contract "can be used to perform a hedging or risk management function." In addition, the industry proposes a specific timetable within which the Commission shall act and a requirement that the Commission specify the grounds for any denial of contract market designation.

Rule Approvals - §5a(12)

Our proposal to amend Section 5a(12) is intended to reaffirm the original limits on the Commission's power to disapprove rules, to reaffirm time limits on the approval process so that the de facto power to force changes by reason of threatened delays is eliminated, and to affirm that an exchange action taken in accordance with a previously approved rule does not constitute a new rule which is subject to the approval process. To this end, our proposal reemphasizes that CFTC rule approval authority is limited to "terms and conditions in contracts of sale" and "other trading requirements" and that disapproval must be based on a finding that the rule violates the Act or a regulation thereunder. A generous timetable for action is set out and the Commission is required to establish a sufficient record in connection with a disapproval proceeding so as to make judicial review a meaningful process.

The Commission's proposal superficially appears to be a step toward industry deregulation, but analysis shows that it is another agency deregulation provision. In addition to the submission of contract terms, the Commission seeks the right of prior approval over any rule of "major economic significance" and that phrase is subject to definition by the Commission. Moreover, the Commission also seeks the right to subject any rule to the approval process (except those relating to the setting of levels of margin) upon the simple expedient of giving notice within 10 days of filing by the contract market. The Commission rejects the concept of time limits on the approval process and seeks to incorporate a standard for approval based on its notion of the general good rather than on the specific, current statutory provisions.

The Commission wants every action, direction and authorization of a Board or a Committee to be deemed a rule subject to prior notification and possible approval proceedings. The business of an exchange cannot operate under so crushing a regime. Instead of easing the regulatory burden, this proposal is likely to call for a substantial increase in the CFTC budget--for "make work" activities which have little or no relevance to public protection.

Position Limits - §4(a)(1)

We urge that the exchanges, which are now responsible for the enactment and enforcement of 90 percent of all position limits, be given front line responsibility for the remainder. The Commission would retain full authority to order that exchange established position limits be revised or amended if it finds that they do not serve their legitimate economic purpose, namely, to deter manipulative activity.

Our proposal will have very little immediate impact on the overall scheme of futures trading in that exchanges are already responsible for most position limits, and those limits previously promulgated by the Commission can easily be made part of existing exchange rules. One desirable side effect of our proposal will be to decriminalize violations of those position limits which have been promulgated by the Commission. Violation of exchange set limits has never constituted a criminal offense. To the best of my recollection, no one has been prosecuted for a violation of limits set by the Commission, although Section 4a(2) makes such violations criminal. It should be obvious that the simple violation of such limits without intent to manipulate or otherwise violate the Act should not be a criminal violation.

The Commission's approach to this same section is dubious at best. Rather than favoring the transfer of front line responsibility for limits to the exchanges, thereby contributing to deregulation of the industry, the Commission asks that its authority to set limits be broadened by the elimination of legislated standards and procedures. The Commission wishes to amend the statute to allow it to act informally, that is without a formal hearing, in the promulgation of limits. A secondary impact of this suggested change will be to amend Section 8a(7) by implication. This will permit the Commission to force exchanges to amend existing rules without affording them an opportunity for a hearing on the record or for a formal appeal.

The Commission cites no historic reason for seeking to expand its powers and eliminate standards to control its behavior, hearings, and appeals. It has no explanation as to why the conduct which is now criminal in only 12 commodities should be made criminal in hundreds.

The industry proposal is intended to place the duty and obligation to set trading limits and police them on the institutions that are most knowledgeable as to the impact of such limits, that have the most to lose if such limits are improperly set, and that are best able to expend the resources to insure their enforcement. This proposal is directly in line with the balance of initiative and oversight originally intended by Congress, and recently articulated by the President in his many statements respecting deregulation of American business.

Standards to Limit Double Jeopardy - Section 6(b)

The Act originally delegated to the exchanges the duty to discipline their own members and persons subject to their jurisdiction. The Commission was given oversight responsibility to correct any exchange that did not act with sufficient severity, or which overreacted. (§8c(1)(B)) In addition, the Commission was granted explicit power to discipline any person for violations of the Act. The phrase "any person" is broad enough to include exchange members. Moreover, violations of the Act are in most cases also violations of exchange rules. It, therefore, developed that the Commission could and would discipline individuals who had previously been the subject of exchange disciplinary proceedings for the same conduct. In fact, it appeared that the Commission was selecting those cases that were easiest for it and which would bolster its record of successful prosecutions, namely, those cases where the exchanges had made a complete record, found liability, and imposed substantial penalties.

Double jeopardy, in addition to being inherently unfair, impairs the investigative ability of the exchanges in the performance of their self-regulatory functions. Individual members who previously were prepared to come forward, admit violations, give the exchanges complete details of the activities of all other traders involved and accept their penalty, have retrenched. Those individuals concerned about a subsequent penalty from the CFTC for the exact same violation have become noncooperative witnesses, stretching the exchanges' enforcement staff and compounding the difficulties of self-regulation. There is no reason why the CFTC should have the power to doubly penalize an individual for the same conduct. Its powers under the Act are now sufficient to revise a penalty if it is dissatisfied with the original sanction. The industry has taken the rather modest position that the Commission should at least make a finding that the discipline imposed was inadequate in light of the magnitude of the alleged offense before commencing a second separate proceeding.

Disclosure of Information - Section 8

We seek to afford information in the possession of the Commission the same protection as that information would have if in the hands of a financial institution subject to the Financial Privacy Act. There is an obvious logical consistency in that extension.

The Commission has taken the opposite position. It seeks to expand its ability to disseminate private, sensitive financial information. It asserts the necessity of forwarding such information to certain state agencies in connection with those provisions of the Commodity Exchange Act which states are entitled to enforce. However, the Commission goes well beyond those purposes and seeks permission to make private, confidential and sensitive information available to political entities at every level in state government down to the municipal level. No sound rationale is advanced for this broad expansion of the confidentiality provisions of the Act. The risks to private parties using the futures markets are obvious, especially where distribution to municipal level governments is involved.

Judicial Review of CFTC Emergency Action - Section 8a

The United States Court of Appeals for the Seventh Circuit ruled in 1979 that the Commission's determination that an emergency exists and its determination as to remedial action to be taken is not subject to judicial review. Thus while Section 8a(9) incorporates a limiting definition of the term emergency and restricts the CFTC's responses thereto, the Commission has been freed from those restraints by reason of the judicial determination that review is not proper. The Commission supports the current state of the law and opposes any attempt to allow judicial review of its emergency actions.

The only check on a Commission "emergency action" is the possibility that Congress will subsequently intervene and amend the statute if the Commission commits a large enough abuse. This, however, is of faint comfort to us in the day to day operation of our business. No harm is done if the possibility of judicial review is reinstated. Moreover, the effect of a judicial check on agency discretion is more likely to cause the agency to restrict itself to the limits prescribed by the statute.

User Fees

You will have heard a great deal of opposition to the user's tax before this hearing concludes, and you may include the Chicago Mercantile Exchange in that category.

To my knowledge, no one in the industry opposes concept of a user fee. We recognize that the CFTC performs certain functions which are primarily for the benefit of futures market participants, and only secondarily for the benefit of the public generally. The cost of such functions, assuming they can be properly delineated, is appropriately chargeable to the industry. That, in fact, is the concept inherent in the National Futures Association. The NFA, now in the process of being established, is intended to perform just such functions, and the cost thereof is to be born entirely by the futures industry. Not one cent of tax dollars is to be used for the support of the NFA.

Other regulatory functions (along with general oversight responsibility) performed by the CFTC are primarily of benefit to the general public, and only secondarily--if at all--beneficial to futures market participants. The cost of those functions is properly chargeable to the taxpayer and should be encompassed within the CFTC's operating budget.

The division of regulatory responsibilities and costs that I have just articulated constitutes sound tax policy, and also reflects sound principles of regulatory management. In other words, this is the way a regulatory agency should function. But it bears little resemblance to the submissions that have been made thus far (1) by the Administration in their January budgetary submission to the Congress, and (2) by the CFTC in its own user tax proposal, which differs substantially from that posited by the Administration.

The Congress should reject the Administration's proposal out of hand, both in the appropriations process and in these reauthorization hearings. That proposal calls for a $23 million CFTC budget in FY 1983, compared to approximately $20 million in FY 1982. All but $1 million of that $23 million budget is to be financed by a user tax. Ignoring the dubious merit of a $3 million budget increase at a time of gigantic federal deficits (and in a trend toward decreased rather than increased regulatory infringement in our society), one must wonder about a proposal that finds only $1 million worth of protection and service for the general public at the CFTC. If that is all there is, the CFTC should be eliminated! There is no rational basis for recommending its continuance as a federal regulatory agency. If, on the other hand, the public interest in risk management and price discovery techniques--the heart of this industry--is greater than that, the proposal is indefensible. It constitutes a totally unjustifiable federal tax.

The CFTC proposal is no more persuasive, though it reportedly is intended to raise only $15 million per year, rather that $22 million. It is not based on a proper consideration of where the regulatory burden of this industry should fall, and who should finance it. Regrettably, that is a task that the Congress will now have to undertake, with little help from the executive branch of government.

Our contention is that a properly organized NFA can readily absorb the so-called "service" functions of the CFTC, and the industry will willingly bear that cost. The other functions should properly be performed by the CFTC, at a cost substantially below that being postulated in the CFTC budget. This means there is no need for the Congress to grant user tax authority to the CFTC. The Commission will benefit significantly by the NFA's assumption of service and other auxiliary activities, and its request for user tax authority can only be categorized as regulatory greed.

CFTC/SEC Jurisdictional Accord

We are relieved that the CFTC and SEC appear to have been able to resolve their differences, but are concerned that the accord and the post-accord conduct of the SEC is founded on a philosophy of securing a competitive edge for the securities exchanges and eliminating, by artificial constraints, existing natural advantages of futures trading.

The stunning success of foreign currency futures trading has obviously made the securities exchanges envious, but envy is not a legitimate reason for expanding the SEC's jurisdiction to cover foreign currencies--a non-security if ever there was one.

The fact that futures transactions do not ordinarily involve debt and are, therefore, exempt from Federal Reserve margin requirements is a structural advantage of futures trading. The SEC's fine hand in the push to impose "equivalent" margin burdens on certain futures transactions belies any notion that the accord is a neutral division of territory. Finally, the accord frees the SEC to authorize an unlimited number of option contracts while the CFTC has limited each exchange to a single contract during the pilot program.

We doubt that it is the function of either the SEC or the CFTC to seek to neutralize the advantages of the entities regulated by the other or to artificially expand the territory of their registrants so that they may take advantage of a good thing. The accord should be modified by Congress to preserve the traditional and logical distinctions between the agencies.

Non-Exchange Issues

I want to conclude with a brief reference to some of the CFTC proposals which impact our members and not the exchange, but which are so misdirected as to further call into question the wisdom of accepting the CFTC's proposal.

Control Person Liability - Section 13

The same poor draftsmanship results in placing responsibility and liability for the acts of such agent-brokers directly on Merrill Lynch's chief executive officer. The Commission defends this result by arguing that it will never exercise its discretionary power to punish control persons unless the equities are on its side. The Commission does not explain how it intends to protect the innocent against private suits. Again, the Congress is asked to rely on the Commission's self-discipline, an unsatisfactory result caused by the Commission's inability to draft a satisfactory statute.

Elimination of Independent Referring Brokers
Sections 4f(1) and 4k(1)

The Commission wishes to eliminate the concept of the independent referring broker and make all such offices associated persons of the futures commission merchant to which business is referred. For example, a Kansas City securities dealer that refers three customers to Merrill Lynch must become an associated person of Merrill, Lynch. If that securities dealer subsequently commits a commodities fraud--entirely unrelated to those customers or any of its dealings with or for Merrill Lynch--the latter will be deemed responsible. This consequence was obviously not intended by the Commission, but its draftsmanship leads to that result.

Automatic Disqualification - Section 8a

The CFTC's proposed amendments to Section 8a include a three page list of offenses which are the basis for a refusal to register or revocation of registration without hearing. The list includes a ten year old state gambling conviction (such as was suffered by the retired poker players in Florida) and a ten year old Commission finding that an individual committed fraud in connection with the sale of a commodity option by not fully informing the customer of all of the facts. Both of the individuals mentioned in the example may have paid their fines and been productive members of the industry thereafter. In fact, it is unlikely that the Commission would now terminate their registrations after having allowed them to continue for several years.

But, the Commission's draft mandates an outrageous result in these two cases. The addition of Section 4k(5) makes it unlawful for any registrant to allow a person to "remain an associated person of such registrant" if the registrant should have known of the ten year old gambling conviction or the stale administrative finding. FCMs will be subject to criminal penalties if they do not systematically investigate and fire persons meeting the requirements of §8a(2) even where such persons have been registered by the Commission after full disclosure. Moreover, the potential for private causes of action by customers who have lost in trades through such individuals is staggering. Again, this would appear to be a case where the Commission's overreaching and inept drafting have led to ridiculously excessive results. Additional examples of the defects in the Commission's proposal are contained in our separate submission.

Conclusion

We in the industry have attempted to provide you with a short, concise legislative package intended to address only the priority needs of this industry and the general public. The philosophy of this proposal is one of placing a heavy burden of regulatory responsibility on the exchanges, and holding them fully accountable for it. It is also intended to place proper oversight responsibility on the Commodity Futures Trading Commission, and give them the legal authority to carry on that responsibility. Finally, it is intended to insure that the CFTC fosters, rather than impedes, the growth and economic well-being of this enormously important industry by requiring considered but decisive actions on proposed rules and contracts. It is likewise intended to stimulate sound management at the CFTC, and a concentration on regulatory issues of importance to the American public rather than on administrative nitpicking.

We believe the CFTC proposal to be typical of what might be expected to emerge from a regulatory bureaucracy intent on preserving and expanding its influence. We deem it contrary to the trend of our times, as evidenced by strong Congressional efforts this past year to make American business more productive and less harassed by stifling and of the CFTC submission. Other portions of that submission are non-controversial and perhaps useful in improving the Act, though not of high priority. We would be supportive of those as a supplement to the industry proposal.

Mr. Chairman, I would be pleased to answer any questions you may have.

STATEMENT OF

BENNETT J. CORN

President

Coffee, Sugar & Cocoa Exchange, Inc.

Congress to be wary of other proposals to reshape the present regulatory structure in radical ways through merging existing agencies or, worse yet, creating new ones. The hedging and price discovery functions of the futures markets are different from the capital formation and investment functions of the securities and other markets. Therefore, the regulation of futures trading should be kept in a separate agency with the requisite expertise to understand the specialized needs and problems of the industry.

A number of proposals for amending the Commodity Exchange Act are being put before this Committee by the industry and by the CFTC. Since you have already received and will continue to receive a good deal of testimony on those proposals, I do not plan to go through them point-by-point. However, there are a few items of direct interest to our Exchange which I would like to highlight.

The most troublesome of the CFTC proposals is the one which would give the CFTC power to impose so-called "user fees," which would be nothing more than a tax levied exclusively on the users of the futures markets. There is no justification for this type of discriminatory tax. It would place an unwarranted burden on an industry that is already spending huge amounts for regulatory purposes, and it would have a number of consequences that are contrary to the public interest.

Since the CFTC first came into existence, the exchanges have expended vast sums on the regulation of the futures markets. To take just our Exchange, in 1976 our total regulatory expenses came to $149,000. Five years later, in 1981, our regulatory expenses came to $2,400,000, an increase of over 1600%. Our compliance and auditing staff has grown from two persons in 1976 to 23 in 1981. At a cost of $1,000,000, we have installed a computerized trading surveillance system, which is by far the most sophisticated and effective in the industry.

As part of its reauthorization package, and in a number of pending regulatory proposals, the CFTC is planning to add substantially to the costs of self-regulation by transferring a number of its responsibilities to the exchanges. One notable example is in the area of handling customer claims, where the Commission is proposing to transfer responsibility from its reparations proceedings to exchange arbitration and to expand greatly the scope and cost of exchange procedures.

The cost of all these measures is largely borne by our members through transaction charges collected by our clearing organizations. In some cases, brokerage firms have been able to pass those charges on to their customers. However, the floor traders, who provide the needed liquidity in our markets, and the commercial firms, which are the principal reason for our existence, have no customers to pass these charges on to.

There is perhaps a temptation to dismiss the significance of the user tax because it would be "only" 12 to 24 cents per round turn (based on the CFTC proposal to raise approximately $16,000,000), or perhaps 25 cents per round turn (based on the OMB proposal to raise approximately $23,000,000). But we all know how government works. This year $16,000,000 or $23,000,000 (depending on which agency's figures you take). Next year $25,000,000. The year after $30,000,000. Since CFTC budgets would be financed by user taxes instead of general revenues, there would be less incentive for the CFTC to be cost efficient, and less incentive for the Appropriations Committees of the Congress to be meticulous in their oversight over CFTC expenditures.

Furthermore the per-transaction costs are based on current trading volumes. But volume in many markets has been declining. If the fee is 25 cents per trade at today's volume level, and if volume declines by 20%, the tax would have to go up to 30 cents just to keep the same amount of revenue. Conversely, if volume rises, the user tax could exceed the agency's budget, thereby starkly revealing it for what it is - another "revenue enhancement" for the already bloated federal government.

There is another insidious facet of the user tax. The CFTC and the futures industry have, with the support of many members of both Houses of Congress, been supporting the establishment of the National Futures Association (the "NFA"), a new self-regulatory body that would fill significant voids in the present self-regulatory structure. A large number of firms dealing with the public in one aspect or another of the commodity business have not been adequately regulated by the CFTC, or by the exchanges. One of the primary functions of NFA would be to take over the regulatory responsibility for this sector of the industry. Another would be to relieve the CFTC of other costly tasks, such as the registration and proficiency testing of professionals, financial surveillance of non-exchange members and auditing of sales practices. The assumption of these obligations by NFA would have the dual benefit of improving public protection while reducing CFTC costs of operation.

However, many exchange members in Chicago, New York and elsewhere have stated that they will oppose NFA if user taxes are imposed. It is not that they are unwilling to pay their fair share; they are simply unwilling to pay twice. And, given the knowledge, experience and beneficial self-interest of those who will be responsible for, and bear the cost of NFA, the fundamental question it seems to me, is whether efficient and cost-effective self-regulation will be given the opportunity to succeed or whether inefficient and costly government regulation will be expanded. To me, the answer is obvious.

The exchanges have proven that self-regulation can and does work. The industry is willing to assume the additional burdens of filling the many regulatory gaps I have already mentioned by funding the NFA. I believe the NFA should be given the opportunity to succeed. It should not be permitted to founder as a result of a user tax because such a result would serve neither the Commission nor the public interest.

For all these reasons, we urge Congress not to adopt the user tax.

Also of great concern to us is the proposal to empower the Commission to become more involved in our day-to-day operations. Currently, under section 5a(12) of the Commodity Exchange Act, the CFTC must approve all exchange rules that relate to terms and conditions in futures contracts or other trading requirements, other than those relating to setting levels of margin. This provision has been one of the greatest impediments to self-regulatory efforts by exchanges since it became effective in 1975. The reason is that the Commission has taken an overly broad view of the "rules" that are subject to its review, and has taken inordinate amounts of time to act upon rules that have been submitted to it. The statute requires the Commission to act on exchange rules within 30 days after they are submitted unless it is not possible to do so. Nevertheless, we have submitted rules that have taken as long as five years to be acted upon. We estimate that each rule filed for approval has taken an average of approximately four to five months to be acted upon.

There has been a great improvement in the processing of rule approvals during the Johnson administration. However, we still have rules that have been before the Commission for as long as five years.

Furthermore, the personnel at the Commission will change over the years, and future administrations could well revert to the practices of old, where extensive delays were routine. Accordingly, we have, in conjunction with the other exchanges, developed a proposal for amending section 5a(12) that will alleviate those problems. That amendment, together with a detailed supporting statement, is contained in the "Recommendations for a Futures Trading Regulatory Improvements Act of 1982" prepared by members of the futures industry and separately submitted to this Committee. We enthusiastically support that amendment and urge its adoption.

On the other hand, we strongly oppose the CFTC proposal for amending section 5a(12). That proposal would expand the categories of rules subject to CFTC approval by adding a new and ill-defined category of rules requiring approval -- namely, rules "of major economic significance" -- in lieu of the present category that includes "trading requirements." Having thus expanded the review requirements, the CFTC proposal does nothing to expedite the process. We therefore regard the CFTC proposal as an exercise in overregulation and urge its defeat.

However, we urge adoption of the CFTC proposal which would enhance the role of the states with respect to policing frauds. That proposal would provide explicitly that other federal and state laws may be applied to prosecute such frauds. Further, state attorneys general and securities administrators would be authorized to take action either in court or administratively against boiler room operators and any persons engaged in CFTC-regulated activity, if they were not registered or designated by the Commission.

In light of the Commission's evident inability to combat fraud in the offer and sale of off-exchange commodity investments, and because any and all fraud taints the entire industry, we support its proposal. We, however, caution against and strongly oppose any amendments to the Act which would diminish or interfere with the Commission's exclusive jurisdiction to regulate any segment of the industry.

We strongly oppose is the CFTC proposal relating to section 13(b) of the Act, which would make any person who "controls" another (without defining the term "control") "responsible" (without saying how or in what way) for violations of law by the person who is "controlled." No justification has been given for this radical extension of the Act. The proposal was derived uncritically from provisions in the securities laws, but without any analysis of whether they would be appropriate as applied to the futures industry or any assessment of what the impact might be.

The CFTC proposal could even have an impact on exchanges if under certain circumstances an exchange might be deemed to "control" its members. In addition, it could result in officials and even unpaid board members of exchanges being held "responsible" for acts or omissions of the exchange staff. Among other things, this could have the undesirable effect of discouraging public members from serving on exchange boards.

This proposal is ill-conceived, and it should be defeated.

The last industry proposal upon which I would like to comment is the suggestion to amend section 8a(9), which gives the Commission extraordinary power to direct exchanges to take any action the Commission deems necessary to maintain or restore orderly trading whenever the Commission believes that an emergency exists. To the great surprise of the entire industry, a court of appeals recently held that action by the Commission pursuant to section 8a(9) is not subject to judicial review. The Supreme Court denied certiorari.* The CFTC has used its emergency power only once in the case of our Exchange, and as it happened we concurred with the Commission in that particular action. However, it seems inconsistent with the fundamental principles of our society for any agency to have the kind of ultimate power that section 8a(9) confers with no judicial review whatsoever. There is no basis for believing that the wisdom of government is any greater than that of the exchanges in emergency matters, and there should be some means of protection against an agency's going off on some misguided or (worse yet) politically motivated course of action. Accordingly, the industry has proposed, and we strongly recommend, that the Act be amended to provide expressly for judicial review of CFTC emergency actions under section 8a(9).

---

* Board of Trade of the City of Chicago v. Commodity Futures Trading Commission, 605 F.2d 1016 (7th Cir. 1979), cert. denied, 446 U.S. 928 (1980).

Mr. Chairman, many proposals for revising the Act are coming before you from the industry, from the CFTC and from other regulatory agencies. Many of these proposals would make revolutionary changes in the regulatory scheme that now exists under the Act. Some of the most radical of these have only recently surfaced, and it is therefore questionable whether they will receive anywhere near the public attention that is necessary for Congress to receive adequate comment and reaction during the course of these hearings. We hope that Congress will not act precipitously on these controversial issues just to meet the reauthorization timetable. We therefore respectfully suggest that this Committee avail itself of the option to defer the controversial issues and to take action only on the noncontroversial items and on those items that are necessary to bring reauthorization about.

Thank you for this opportunity to present our views. I will be pleased to answer any questions you may have.

STATEMENT OF DAVID H. MORGAN, PRESIDENT, MIDAMERICA COMMODITY EXCHANGE

Good morning, Mr. Chairman and Members of the Committee. I am David H. Morgan, President of the MidAmerica Commodity Exchange. Nearby is our Washington Counsel, John Rainbolt, a former Vice Chairman of the Commodity Futures Trading Commission, as well as a former Counsel to the House Committee on Agriculture. John and I will be happy to answer any questions following this statement. Because of the limited time for testimony, we request the opportunity to file comments on specific proposals offered at these hearings and hope the record will remain open for a time sufficient to accommodate such filings.

I. INTRODUCTION

MidAmerica Commodity Exchange, among the oldest in the nation, was incorporated in 1880. In our one-hundred plus years of existence, MidAmerica has endeavored to provide smaller producers, merchants and users of agricultural commodities with the opportunity to enjoy the risk-management benefits associated with futures markets. We have done this by having the capability of offering smaller-sized contracts in grains and in livestock, 1/ and

---

1/ 1,000 bu. corn, wheat, soybeans, oats; 15,000 lbs. live hogs; 20,000 lbs. cattle.

through the existence of our "changer" rule, [2] a unique form of institutionalized arbitrage between MidAmerica and other, larger exchanges. We are proud of the success of these smaller sized contracts, and of their high utility to agricultural producers in conducting hedging programs. A recent survey conducted by the Exchange indicated that over 70% of the orders in our live hog contract are hedging orders.

In recent years, in an effort to expand our horizons into other areas, we have broadened the scope of the exchange to include precious metals, [3] and in September of 1981, we introduced a Treasury bond contract. We presently have proposed contracts pending at the CFTC in Treasury bills, gold coins, options on T-bonds and a 40,000 pound domestic refined sugar contract which will be unique to the industry.

The smaller U.S. exchanges, such as MidAmerica, will be profoundly affected by the outcome of the reauthorization hearings. Smaller exchanges are the most vulnerable to the negative effects of adverse economic conditions, delays in contract and rule approvals, and inefficient and excessive regulation. It is essential to our continued viability that Congress consider how its decisions on the proposals proferred by the Commodity Futures Trading Commission ("CFTC" or "Commission"), which include the enactment of a user fee and additional regulations, will impact upon the smaller contract markets as well as those who enjoy the larger market share.

---

[2] Changing involves the purchase or sale of a commodity between a "changer" and another member, which on the part of the changer is part of a spreading transaction between MidAmerica and the changed market. Changing is unique to MidAmerica and keeps our markets priced in line with other futures markets.

[3] 1,000 oz. silver; 33.2 fine troy oz. gold.

MidAmerica acknowledges the benefits derived from the regulatory oversight provided by the Commodity Exchange Act. Since its establishment in 1974, the industry has been able to develop new product lines to help individuals and industries engage in risk-management through futures contracts introduced in many diverse fields of commerce. MidAmerica believes that the continuance of the Commission's exclusive jurisdiction over our industry is the most effective way to fulfill the Congressional mandate that the commodity futures industry function in a manner to serve the public good.

By the same token, our Exchange--our industry--are captives of the CFTC. The Commission has life or death authority over our marketplace, and while we do not believe that authority has been exercised maliciously, it has occasionally led to needless hardships at our market. The commonality of our experiences with those of other exchanges compels us to seek amendments to the current law, as well as to comment on proposals recommended by the Commission, and currently presented in S. 2109.

II. EXTENDING THE LIFE OF THE COMMISSION WITH AMENDMENTS

MidAmerica supports continued authorization for appropriations for the CFTC for an additional four years, provided necessary amendments are made to the Act.

At the top of our list of necessary amendments is streamlining the Commission's review process for new contracts. MidAmerica was not particularly concerned about such matters in 1974, when this Committee created the Commission and spelled out its powers over the industry, nor were our concerns overwhelming in 1978, when the Act was extended another four years.

However, in the ensuing four years the Commission, partly for reasons not of its own making, has finally managed to get our attention in a fairly direct manner. It has barred us--hopefully temporarily--from competition with other, larger exchanges. Like other exchanges, we found there was little we could do about the situation.

A. NEW CONTRACTS ARE THE LIFEBLOOD OF THE FUTURES INDUSTRY

The significance of new contracts was recognized by the House Agriculture Committee when it considered the legislation which ultimately became the Commodity Futures Trading Commission Act of 1974. At that time, the Committee indicated to the CFTC that it intended "...that useful and beneficial new contracts be encouraged, rather than discouraged," and that "the Commission look to the marketplace as an economic justification of the contract or proposed contract in question." 4/

Despite this unambiguous statement of Congressional intent, it has not beem uncommon for the Commission to delay years before acting upon an application for contract market designation. Although the Commission has recently accelerated the pace of new contract approvals, we are puzzled that such heavily touted activities have offered little relief to our Exchange. In fact, several contract applications submitted by other exchanges subsequent to MidAmerica's long outstanding T-bill contract submission

---

4/ H. Rep. No. 93-975, 93rd Cong. 2nd Sess. 29 (1974).

have attained Commission approval while MidAmerica's contract has not.

True, Congress recognized the stranglehold the Commission exercises over new contracts and, in 1978, amended §6 of the Act to provide that when the Commission denies a market's application, there must be a "hearing on the record." However, it did not address the issue of a market's remedy to bureaucratic delays. These delays have the effect of denying the contract market application for the period the contract is in bureaucratic limbo. §6 of the Commodity Exchange Act currently provides no realistic mechanism for an exchange to challenge staff judgments that an application is not in compliance with the Commission's "public interest" and other tests to which the contract is subjected. The effect of such informal determinations is to halt work on the contract without constituting formal denial of the application.

B. THE EXCHANGE'S AGONY: THE CFTC CONTRACT MARKET REVIEW PROCESS

We suspect that each U.S. exchange has an example that can be cited to this Committee of what can happen to a market whose contract is subject to the CFTC designation process. For our part, we call the Committee's attention to MidAmerica's September, 1979 application to trade $500,000 Treasury bill ("T-bill") futures, the contract terms of which were similar to those of a contract already approved by the CFTC and actively traded at another exchange:

1. SEPTEMBER, 1979 Supported by potential hedging interests, MidAmerica's T-bill application was sent to

the CFTC. The contract was identical (but of smaller size) to another contract already approved by the CFTC. However, in a first round of communications, the proposed T-bill contract was targeted by Commission staff members as possibly drawing too heavily on existing deliverable supplies. While MidAmerica could document empirically that deliveries would not materially increase pressure on existing deliverable supplies of Treasury bills, the Exchange amended its application in an attempt to alleviate staff objections. These amendments, however, did not abate staff reluctance to approve the contract. CFTC staff stated that it would not recommend approval of a contract if it drew down on existing supply "of as much as a single T-bill."

[Note: Between these communications and the next event, the T-bill contract entered bureaucratic limbo. During the interim period, staff at the CFTC would approve no futures contracts, since all available staff were involved in the "Stewart" amendment study mandated by §21 of the Act.]

2. MARCH, 1981 Following the study, the Federal Reserve Board communicated to the CFTC that there was no reason to object to the MidAmerica contract. However, deprived of a forum to challenge CFTC staff's reluctance to approve the contract (now, as amended), the Exchange proposed additional amendments--a new delivery cycle--to make some progress toward Commission approval.

3. MARCH, 1981 Following the delivery cycle amendments, the Exchange was told that it could optimistically expect favorable consideration of the contract within one month.

4. APRIL, 1981 CFTC staff members recommended the Exchange adopt a new delivery mechanism. The Exchange complied.

5. MAY, 1981 The Exchange was informed that MidAmerica's application would now have to await approval on a similar contract from another exchange.

6. SEPTEMBER, 1981 Despite earlier statements, the Exchange was now informed that the contract could not be approved because it would "draw too heavily on available deliverable supplies."

[Peculiarly, the very next day Chairman Johnson, in speaking to the Banking Institute, stated that deliveries against financial futures contracts "are relatively light" and that Treasury bill deliveries "have rarely equalled one day's trade in the dealer market."]

7. OCTOBER, 1981 MidAmerica again amended its application in order to resolve any potential delivery supply "problems"--problems which in MidAmerica's opinion have never existed. Following conversations with CFTC staff members, the contract was amended to call for cash settlement. The exchange was informed that it may optimistically expect a favorable staff recommendation by January, 1982.

8. JANUARY, 1982 With volume declining at the Exchange, the contract application was further delayed by a Commission directive to staff that it devote all its resources to moving the Index Futures application of the Kansas City Board of Trade forward for Commission consideration.

9. FEBRUARY, 1982 Precisely 888 days have now passed since the application was first submitted to the CFTC. The contract has still not been approved. 5/

* * * *

MidAmerica has been buffeted by contradictory and confusing demands that the contract be amended if it were ever to be allowed to be traded.

5/ This schedule of events represents a small fraction of the many communications either through correspondence, telephone or personal meetings, between Exchange and Commission staff concerning MidAmerica's T-bill application.

During the course of its consideration of the exchange's application, the CFTC staff delayed approval of the contract based on (1) the deliverable supply of the underlying commodity, (2) the delivery cycle chosen, (3) the delivery mechanism. Yet these cycles and these mechanisms--indeed, the contract itself--almost exactly tracked contracts at other markets--and the CFTC has never acted to force its proposed "corrections" on competing exchanges under §5a(8) of the Act.

In point of fact, MidAmerica knows--and the CFTC should have known--that expected deliveries on its proposed contract would have been minimal compared with the other contracts (in fact, following passage of Title V of the Economic Recovery Tax Act of 1981, incentive for delivery of T-bills against any futures contracts was all but totally eliminated).

In a final, bitter irony, shortly following MidAmerica's final amendment of its contract to provide for cash settlement, the Joint Tax Committee ("JTC") staff adopted an interpretation of §501 of the recently enacted Tax Act that, if upheld, would impose a higher rate of taxation on profits on cash settlement contracts than for those that call for actual delivery of the underlying commodity. Thus, when MidAmerica's contract does begin trading, profits in our futures contract may be taxed at 50%, while traders only three blocks away, trading in a contract identical in every respect (save size) to the MidAmerica contract, will be taxed at only a maximum 32% "blended" rate because they deliver physical bills and MidAmerica does not.

MidAmerica's frustrating experience with bureaucratic delay at the CFTC is not singular. An ad hoc industry committee examining the CFTC's contract approval process found:

> "During the period 1975-79 the CFTC required an average of almost one year to process applications for contract market designation. Stock index applications have been pending since 1978. As of June 30, 1981, thirty-seven applications for designations were pending before the CFTC. Of these applications, one had been pending since 1977, one had been pending since 1978, nine had been pending since 1979, and sixteen had been pending since 1980. Ten of the pending contracts were submitted in 1981." (Footnotes omitted) 6/

A CFTC non-decision on contract applications is, in fact, a decision to deny the contract application for a certain time. Under present law, exchanges have no recourse to combat bureaucratic delay in processing contracts.

On the other side, however, the CFTC will not tolerate the same delay in responding to staff requests for information regarding contracts. A September 17 letter to all U.S. exchanges stated "We will deem an application to be voluntarily withdrawn if no written response on the merits of our inquiry is received within 90 days after the inquiry was sent." 7/

6/ Recommendations for a "Futures Trading Regulatory Improvements Act of 1982", U.S. Commodity Industry Submission to Congress (p. 37).

7/ CFTC correspondence, September 17, 1981, to exchange presidents imposing a three-month deadline for response to CFTC inquiries, or the application will be deemed to be "voluntarily withdrawn."

RECOMMENDED AMENDMENT TO §6 OF THE ACT

MidAmerica seeks parity in the exchange contract designation process. MidAmerica does not seek to force the Commission to approve a contract which is unsuitable for trading. What we do propose is a mechanism whereby an exchange can get a decision out of the CFTC. Consistent with the Commission's requirements that exchanges respond within a certain timeframe to CFTC requests for further information regarding exchange contract applications or the application will be considered dead, the Commission should be required to approve or disapprove the contract application within six months. If the application is denied, the exchange will be entitled to a hearing on the record under existing §6.

Accordingly, Section 6 of the Act should be amended to read as follows:

> "Section 6 of the Commodity Exchange Act (7 U.S.C. 8) is amended by striking out that part of the second sentence from the beginning thereof up to and including "with" and inserting in lieu thereof the following:
>
> > "The Commission shall approve or deny an application for designation as a contract market within six months of the filing of the application, and if it denies the application, it shall specify the grounds for the denial. Any board of trade whose application has been denied shall be afforded a hearing on the record before the Commission within thirty days after the filing of a request for a hearing so long as such request is filed within ninety days of the denial of the application. The board of trade shall have"."

III. OTHER LEGISLATIVE PROPOSALS
S. 2109

The CFTC has submitted draft legislation to Congress (S. 2109) proposing to amend the Commodity Exchange Act in several key particulars. The thrust of the bill is to accumulate more power to government over futures markets and, alternatively, does little to address legitimate problems raised by industry. While there are minor amendments contained in both bills that we can support, aspects of the Commission's proposals are so troublesome as to deserve more than passing reference. Comments on some of these proposals follow:

A. TRANSACTION FEES: [§26] [8] MIDAMERICA OPPOSES TRANSACTION FEES AS CONTEMPLATED BY S. 2109.

The outcome of these reauthorization hearings will profoundly affect the smaller exchanges such as MidAmerica Commodity Exchange.

For us, it is essential that regulation at all levels be cost efficient. In current economic uncertainties, MidAmerica is facing difficulties similar to those experienced by other small businesses in our nation. Our membership prices, among the lowest in the industry, provide entry into the marketplace by average income earners, many of whom are in pursuit of a new profession. Our income is a function of volume, which has declined 15% over the last six months as compared to the first half of 1981. Yet the same volume must continue to fund exchange operations, will be requested to be used to fund NFA and, as now proposed, will also be used to fund the CFTC.

A proposed transaction fee of 12¢ per contract (round

8/ Citations are to S. 2109.

turn) is not a great amount in the scheme of things. Inevitably, however, a 12¢ fee leads to yet a larger fee; in two or three years, 12¢ becomes 50¢ or one dollar. A federal transaction fee will encourage a state, or municipal transaction fee, and the snowball, once rolling does not easily stop; it simply grows larger and larger. Even so, we could possibly live with the proposed fee, but for our other objections to the fee concept, which are as follows:

1. THE PROPOSED USER FEE HAS EFFECTIVELY INTERDICTED FORWARD PROGRESS OF THE NATIONAL FUTURES ASSOCIATION

MidAmerica was one of the few exchanges that directly appeared before the CFTC to support NFA's application. MidAmerica believes the industry must have NFA if it is to survive as a comprehensive industry in its own right. However, user fees have jeopardized exchange support for NFA. While at first glance this might be thought to be "only" an internal industry issue, anything that slows NFA weakens the drive for higher standards and greater customer protection in the industry. We oppose anything that slows NFA.

2. THE U.S. COMMODITY INDUSTRY GETS LITTLE FOR ITS MONEY FROM THE CFTC

From its recent experience with the budget reconcilation process, the Committee is aware that user fees are commonly levied when government provides a benefitial service to individuals--as in inspection and grading standards for agricultural products, CFTC registration fees, and the like. But what do traders get from the CFTC?

The CFTC has, on more than one occasion, demonstrated inept regulation. Required to approve exchange contract specifications before they can become effective (as we have noted earlier), the CFTC's contract approval process has acted to freeze exchanges out of the marketplace for years. Similarly, the Commission has yet to approve some exchange rules pending before it since 1975. Consistent with this pattern of delay, the CFTC so impeded approval of options on U.S. exchanges that competing securities exchanges were able to establish an all but impregnable beachhead in the exempt securities options marketplace--while exchanges regulated by the CFTC have yet to list options for trading. Yet the CFTC now proposes to tax traders for these questionable "benefits"?

3. THE PUBLIC IS THE BENEFICIARY OF U.S. COMMODITY TRADING

There is more public benefit than trader benefit from regulation of U.S. commodity markets. Almost daily, virtually every American "borrows" something from U.S. futures markets: a housewife hears sugar is going up or down, and purchases accordingly; a farmer or baker prices his products directly off futures markets; other commodities--from crude oil to interest rates--in industry and consumer circles alike, are also priced off futures markets.

In addition to their function as a thermometer for price, U.S. markets serve as "shock absorbers" for fluctuating markets in raw materials. It can be statistically shown that markets gyrate less in those commodities that are traded on futures markets, than where such markets do not exist. Merchants who can hedge raw material costs are able to pass on cost savings to consumers. The federal government does not regulate commodity markets for the benefit of the individual trader, but because Congress has declared futures markets are affected with a "national public interest" (7 USC §5).

To tax traders for these benefits is not only unfair to the industry, but destructive of the long-term best interests of a well-regulated U.S. industry where exchanges, the CFTC, and the NFA--the latter funded by industry transaction fees, each pull its fair load.

We urge the Subcommittee not to include transaction fees in its legislative recommendations.

B. CFTC/SEC JURISDICTIONAL "ACCORD": [§2, §5, §10 OF S. 2109] Our objections to the Committee approving, at this time, amendments codifying the accord are based on two grounds; procedural and substantive.

1. PROCEDURAL: WE BELIEVE FOR THE AGRICULTURAL COMMITTEES TO ACT ON THE CFTC/SEC "ACCORD" AMENDMENTS AT THIS TIME, WITHOUT ASSURANCE FROM THE RELEVANT SEC OVERSIGHT COMMITTEES THAT THEY WILL HONOR THE "ACCORD," IS COURTING DISASTER FOR THE COMMODITY INDUSTRY.

CFTC exclusive jurisdiction was among the most valuable--in fact, the most valuable--protection provided the industry in 1974 when this Committee created the CFTC. It must not be lost through accident. We are alarmed that the CFTC and SEC had no understanding with other Committees charged with responsibility over the relevant securities acts that they would honor the agreement before submitting it to Congress. To the contrary, in the House, the Chairman of the Energy and Commerce Committee in the House has now introduced legislation, H.R. 5515, to halt trading of securities index futures by commodity exchanges. [H.R. 5515, however, carefully exempts securities exchanges from its proposed ban in trading index-related instruments.] The concept of cash settlement, a key ingredient of the jurisdictional accord respecting stock index futures, is also under attack from the same and other quarters. Finally, §2 of the relevant CFTC proposal seems to envision that it is amendments to the Securities Acts that must precede enactment of the CFTC proposal, [9] but hearings by those Committees may not occur until after the Agriculture Committees have been expected to act on this legislation.

Thus, it is apparent that the political environment for enacting legislation of such momentous consequence at this time is far from desirable.

Noting that the CFTC acted within its full authority recently to approve the application of Kansas City for its stock index future, we recommend that, unless the necessary assurances are available, the CFTC amendments to the jurisdictional "accord" be separated from the bill for further action if and when there is uniform agreement as to the contents of both amendments to the respective commodity and security acts.

2. SUBSTANTIVE: Frankly, we see little substantive merit--and some conceptual confusion--in the following aspects of the agreement:

---

[9] See S. 2109, p. 4. The Commission's legislation seems to contemplate that Congress will, sometime in the future consideration of S. 2109, amend §2 so as to reference relevant amendments of the Securities Acts, as part of the "accord".

a. Ceding jurisdiction to the SEC in options on foreign currency. Foreign currency is certainly a well-established commodity future. However, if the Committee chooses to amend this section of the Act, the words "foreign currency" should not be deemed to include gold or silver coins. Coins have been a commonly traded commodity since before the CFTC was created, and to authorize their trading as securities will further confuse any progress that might otherwise be represented by the proposed CFTC/SEC accord.

b. Barring futures in municipal securities. Why? Similar to GNMA certificates, Treasury Bils, and Treasury Bonds, these are exempt securities and all other exempt securities are the subject of successful--and highly useful--futures contracts.

c. Ceding jurisdiction over physical options on exempt securities to the SEC. Except for listed securities, the CFTC should be the prime regulator for all options traded on exchanges. Options, like futures, are risk-shifting market instruments. They are intangible rights in things, not things themselves. All exchange-traded market instruments on anything but listed securities properly are regulated exclusively by the CFTC.

C. PROPOSED INFORMAL RULEMAKING AUTHORITY ON SPECULATIVE LIMITS [§4]: Section 4 of the Commission's proposal seeks to replace the current procedures for government-imposed speculative limits in the Act with informal CFTC rulemaking authority to impose limits.

MidAmerica opposes this proposed change. Under existing law, the CFTC can promulgate, by order, speculative limits after notice and a hearing on the merits of the proposal, with the opportunity for government, economists, industry, and other experts to present evidence. The CFTC proposal would replace these procedures with informal rulemaking, which offers few protections for the affected marketplace or its customers.

However, in point of fact neither the current law nor the CFTC proposal represent enlightened thinking on the speculative limits issue. Economic thinking has changed and developed substantially since the 1930's when the present law had its heyday. The benefits of speculation have been acknowledged, 10/ and it is now recognized that speculative limits may act as artificial barriers to trading and thereby result in inefficient markets. 11/

The current movement toward deregulation of the economy is directly contrary to the overly broad regulation that is encouraged both by the statutory language as it now stands and by the CFTC proposal. The only legitimate rationale for speculative limits

---

10/ See Report of the CFTC Advisory Committee on the Economic Role of Contract Markets, Comm. Fut. L. Rep. (CCH) ¶20,197 (1976) at 21,071:

> "Speculation is a vital beneficial force in futures markets. Speculators bridge the time gap between short and long hedgers. They also provide independent price judgments which help to assure producers and consumers a price truly reflecting anticipated supply and demand. Far from being discouraged, speculation should be encouraged to continue its positive role in the markets."

11/ See "Speculative Limits," a staff paper prepared for Commission discussion by the Office of the Chief Economist, CFTC, June 24, 1977, at 3, 22-23.

is their potential for preventing market manipulation or squeezes, and limits should be allowed only to the extent they promote this limited objective.

We recommend that Congress amend §4a of the Act, not only to remove its antispeculative bias, but also to reallocate to contract markets initial responsibility for establishing speculative limits. Criteria (manipulation, corners, and squeezes) and standards (volume, open interest, and arbitrage) should be established upon which the Commission may, after a hearing on the record, order a contract market to amend its rules pertaining to limits.

Experience demonstrates that without a requirement that the Commission consider volume and open interest, limits will be set at unduly low levels. The speculative limits on wheat, for example, have been increased only once since 1938, (from 2,000,000 bushels to 3,000,000 bushels) in 1976. 12/ The percentage increase in open interest during this period, however, has greatly exceeded the percentage increase in limits so that limits are now far lower in relation to open interest than they were in 1938. 13/

Similarly, the requirement that the Commission consider arbitrage between the futures markets and other markets (including "changer" activities) would insure that speculative limits are imposed only in situations where they are necessary to prevent

---

12/ Limits on Positions and Trading in Wheat. Comm. Fut. L. Rep. (CCH) ¶20,199 (1976).

13/ *See* Report of the CFTC Advisory Committee, *supra*, n. 2 at 21,075.

manipulation. Arbitrage between cash and futures markets, between domestic markets, and between foreign and domestic markets, greatly reduces the potential for a large futures position to affect prices. [14] Where natural market forces thus accomplish the purpose that would otherwise be served by speculative limits, the need for limits is reduced or eliminated.

IV. TOWARD REALISTIC COMMODITY REGULATION IN THE 1980s

We have previously announced our support for CFTC Reauthorization, together with an amendment to current §6 of the Act to provide a deadline and hearing opportunity for Exchange/CFTC disputes over contract market applications, and amendments to the Act's speculative limit provisions (found in §4a).

Additionally, MidAmerica supports:

A. MODERNIZATION OF LEGISLATIVE FINDINGS: Amending §3 of the Commodity Exchange Act containing 1922 "legislative findings" to remove its anti-speculative bias and to restore the word "options."

B. RESCINDING THE BAN ON OPTIONS ON ENUMERATED COMMODITIES: Amending §4c of the Act (which presently bans options on certain domestically produced agricultural commodities traded as futures on U.S. contract markets) to allow options on such commodities to be traded on U.S. exchanges designated by the Commission as a contract market for the underlying commodity.

C. EXCHANGE RULE APPROVALS: Amending §5a(12) of the Commodity Exchange Act to expressly provide that the term "rule" is limited to rules of general applicability, and does not encompass actions which implement or interpret rules. Also, amending §5a(12) of the Commodity Exchange Act to require the CFTC, in disapproving a rule, to specify the specific section or sections of the Act (including §15) that the rule would violate; to provide that, if the CFTC has not instituted disapproval proceedings within 60 days after the filing of a proposed rule, or if instituted within 60 days and such proceedings have not been completed within 180 days, an exchange may put such rule into effect, and subject to the provisions of §5A(8) of the Commodity Exchange Act; and to eliminate certain publication requirements. Finally, amending §5a(8) of the Commodity Exchange Act to codify CFTC Regulation 1.53.

---

[14] *Id*. at 21,072.

D. EMERGENCY POWERS: Amending §8a(9) of the Commodity Exchange Act to provide expressly for judicial review of both CFTC "emergency" determinations and the remedial actions prescribed.

E. INTRODUCING BROKERS: Amending various sections of the Commodity Exchange Act to provide for the direct regulation of "introducing brokers" and their employees.

F. LIMITATION OF DOUBLE JEOPARDY: Amending §6(b) of the Commodity Exchange Act to afford protection against successive penalties for the same conduct.

V. CONCLUSION

We would remind the Committee that this is not the best of times for exchanges as institutions. In the last six years, three new exchanges have encountered the harsh realities of the marketplace in attempting to start new markets; although we would wish to the contrary, none may survive another year if present trends continue.

MidAmerica, to the contrary, has survived through 100 years--22 presidents, the depression, five wars--even the first seven years of the CFTC. We have survived because we have been able to provide a marketplace for smaller producers and traders, where none was previously available, and through our ability to list new contracts in response to changing needs of the economy and our customers.

The Exchange will continue to survive if the CFTC does not thwart MidAmerica's ability to develop or trade new contracts. We are alarmed at some tendencies that we see at the CFTC and, while they may not be the subject of legislation, they are important to the Committee's oversight role in reauthorizing the Commission.

A. The first of the CFTC tendencies that concerns us has been the appearance of a "bigger is better" philosophy that only larger contracts are really "acceptable," while smaller contracts are somehow "suspicious" and are not trade-oriented. While many of our smaller contracts do attract speculators who prefer not to engage in larger positions, they also provide a forum for small producers to hedge cash market risk.

B. The second tendency has been to denigrate speculation as a viable economic role. The Commission should realize that in the real world, a useful, "economically purposeful" contract can, at times, be made up almost entirely of speculative positions. Speculation provides liquidity, and liquidity offers both valid price discovery and a forum to offset hedging orders.

C. A third tendency has been to retard innovation in the development of market instruments. The classic example, failure to move more rapidly on the options pilot program, has already been mentioned; the same point could be made on stock index futures, and options on physicals. While it may not arguably be the Commission's role to encourage any market, neither should it be its role to discourage legitimate markets. We live in a time of change--for the industry as well as government. In other words, this is a time when some regulatory flexibility is needed both at the CFTC and in the industry.

As the Committee addresses the amendments we have proposed, as well as those proposed from the CFTC and other quarters of the commodity industry, we would ask it to keep in mind that MidAmerica and its customers play an important economic role in the diversified commodity marketplace of today, and that we are just as serious about continuing to fulfill that role as the CFTC is about fulfilling its. We ask that you balance the sometimes competing interests before you today and come down squarely in favor of a realistic regulatory "package" that will strike the proper balance between the needs of free markets, and bureaucratic convenience.

I look forward to your questions.

Thank you.

STATEMENT OF DAVID W. GIBSON, SECOND VICE PRESIDENT, AND WALTER VERNON, EXECUTIVE VICE PRESIDENT AND CHIEF EXECUTIVE OFFICER, THE BOARD OF TRADE OF KANSAS CITY, MO., INC.

I. Summary

The Kansas City Board of Trade supports the reauthorization of the commodity futures trading commission and would like to offer the following suggestions for your consideration during the reauthorization process:

1. Reauthorize the Commission for a longer period of time, perhaps six to ten years. Such an action would conserve the time and energy of both the industry and the government.
2. Establish a broadly based advisory committee similar to that which was established a year ago for the Federal Grain Inspection Service. The purpose of which would be to;
   a) study the impact of the establishment of the National Futures Association on the CFTC's activities, its budget and proposed user fees,
   b) consider segregating the CFTC's budgeted expenditures which relate to market surveillance in the "public interest" and funding those expenditures through congressional appropriation, at the same time establishing realistic users fees which relate solely to specific services provided by the CFTC, such as registration of brokers and associated persons, new contract proposals by exchanges, etc. In addition, the committee could review functions which could be delegated to the NFA.
3. We propose that the Congress ratify the recent agreement between the CFTC and the SEC concerning jurisdiction. This agreement will provide solid guidelines to enable government to deal effectively with the ever expanding volume of new contract proposals by the various exchanges.

4. We suggest that Congress not permit any change in present laws which would permit trading in options on agricultural items such as wheat. The experience of our members who witnessed such trading during the 1930's seems to indicate that the result was not satisfactory.
5. In general, the KCBT supports the commodity industry proposal on reauthorization. However, we do oppose time limits on new contract proposals.
6. The KCBT recommends that Congress change language in two places, by deleting the word, "margins," and replacing it with "customer deposit" in Sections 8(a)7(c) and 5a.12, to avoid confusion.

II. Discussion

1. We have recommended that the CFTC be reauthorized for a period of eight to ten years.
   a. Other federal agencies are not required to seek reauthorization every four years. SI and HRI to establish Sunset legislation for all government agencies suggest that the appropriate time for reauthorization should either be ten or twenty years.
   b. The present four year reauthorization cycle is time consuming and costly for both the Congress and the industry. In addition, we believe that the brevity of the present cycle retards the normal development of agency programs and policies by heightening the political environment in which the Commission must operate. A longer term would create a more stable Commission.
2. We have suggested that the role of the CFTC be re-examined by the Advisory Committee in light of the establishment of the NFA. That committee should also study the imposition of users fees which would be directly related to services provided by the CFTC.

a. We believe that such a review conducted by an Advisory Committee made up of experts from the various markets industry users, government officials and management experts would result in sound recommendations to Congress as to the scope of the CFTC's oversight activities as well as an equitable distribution of the costs involved.

b. The Kansas City Board of Trade is accutely aware of the budgetary pressures which face the Congress, the administration and the American people. However, we do not think that a uniform tax on all commodity market users is appropriate. By way of example, the imposition of such a tax on agricultural hedgers would result in yet another cost being transferred to farmers already burdened by declining farm prices and escalating costs.

c. The exchanges, as self-regulatory bodies, could continue to regulate the conduct of their respective members while the NFA could undertake regulation of the FCMs dealing with the public. Both are under the general oversight of the CFTC.

3. Ratification of the CFTC/SEC Agreement

a. In recent years, we have witnessed a virtual explosion in new futures contracts and contract proposals. Many of which are financial in nature. The agreement between Chairman Johnson and Chairman Shad was a very practical attempt to deal with the areas where the functions of their respective commissions overlap. The Kansas City Board of Trade applauds this very sound approach to a vexing problem.

b. Congressional ratification of the agreement would eliminate the industries with duplicate federal oversight.

4. The KCBT is opposed to any change in present law which would permit trading in options on agricultural commodities such as wheat.

   a. We have reviewed this matter with members, as well as other industry experts who were active during the 1930's when such options were traded. The uniform conclusion of those experts was that options did not serve as a satisfactory method of trading.

   b. We understand that the National Grain and Feed Association has suggested that a study of one to two years in length be conducted prior to approval of trading in agricultural options. At the very least, we urge the Congress to follow that suggestion.

5. In general, the KCBT supports the commodity industry proposal on reauthorization. However, we do oppose the imposition of time limits on new contract proposals.

6. There has been some confusion over the word "margin," since it is also used in the securities regulatory system, where it refers to an extension of credit for the purchase of securities. By contrast, the word, "margin," in commodities means a customer deposit. It serves as an earnest money deposit which guarantees performance. Both buyer and seller put up a deposit, and nothing is purchased. Thus, the KCBT recommends the word, "margin," be changed to "customer deposit."

We sincerely appreciate the opportunity to express our views to this committee. We believe that the CFTC is an important regulatory agency with a legitimate, albeit evolving role to fulfill. We strongly urge that it be continued as a separate commission. We recognize the call in some quarters for its inclusion in a U. S. commission on exchanges, but respectfully suggest that there is a distinct functional difference between commodity trading (hedging) and that of other markets (such as capital formation and secondary trading of equity securities).

In the event that you require additional information, we will be happy to supply it at your request.

KANSAS CITY BOARD OF TRADE

The Board of Trade of Kansas City, Missouri, Inc., or better known in the grain and futures trade as the Kansas City Board of Trade, was founded in 1856, 126 years ago. Except for a brief interruption during the Civil War, it has been a major market for grain and later grain futures since that time. Initially, it was important only to the local area and later the midwest; but in the last 15 or 20 years has, in fact, become a world market due to the worldwide dependence upon Hard Red Winter wheat--the kind traded at the Kansas City futures market.

As a self-regulatory body, it has for years established rules and regulations for the orderly trading of grain and futures contracts. Yesterday, trading began in the Value Line stock index futures contract.

(The folling proposed amendments were inserted by Henry Eschwege, Director, Community and Economic Development Division, General Accounting Office, see p. 175 for the oral testimony of Mr. Eschwege.)

PROPOSED AMENDMENTS TO THE COMMODITY EXCHANGE ACT

To amend the Commodity Exchange Act to broaden the regulatory powers of the Commodity Futures Trading Commission and to authorize the delegation of various Commission responsibilities to registered futures associations.

Be it enacted by the Senate and the House of Representatives of the United States of America in Congress assembled,

Sec. 101: This act may be cited as the "Commodity Exchange Act Amendments of 1982."

Sec. 102: In order to authorize the Commodity Futures Trading Commission to delegate its registration functions set out in section 8a (1)-(4) of the Commodity Exchange Act, as amended, and to allow appeals to the Commission from decisions of registered futures associations, section 8a of the act is further amended by adding a new subsection (10) to read as follows:

> "(10) to delegate to a registered futures association the registration functions listed in paragraphs (1) through (4) in accordance with rules approved by the Commission and subject to the procedural hearing requirements contained therein: provided, however, that any person subject to an adverse decision by a registered futures association may appeal such decision to the Commission who shall afford such person an opportunity for a hearing on the record."

Sec. 103: In order to authorize the Commodity Futures Trading Commission or its designee to establish examination standards for commodity trading advisors and commodity pool operators, section 4p of the Commodity Exchange Act, as amended, is further amended by inserting the phrase "commodity trading advisors, commodity pool operators," before the phrase "futures commission merchants, floor brokers, and those persons associated with futures commission merchants or floor brokers" where it appears in the first, second, and third sentences thereof; and by inserting the phrase "commodity trading advisors and commodity pool operators" at the end of the fourth sentence thereof.

Sec. 104: In order to clarify section 17 of the act, to expressly authorize a registered futures association to collect the fingerprints of its members, and to submit those fingerprints to the FBI, section 17(b)(4)(E) of the act, as amended, is further amended by adding at the end thereof the following:

> "* * *, which may require the applicant to be fingerprinted and to submit, or cause to be

> submitted, such fingerprints to the Attorney General for identification and appropriate processing."

Sec. 105: [Should the Congress decide to provide aggrieved commodity purchasers an explicit cause of action against commodity professionals who violate provisions of the act,] section 14 of the act, as amended, is further amended by adding a new subsection (j) to read as follows:

> "(j)(1) As an alternative to the procedure otherwise provided by this section or any other provision of this act, any person who is injured by a violation of any provision of this act or any rule, regulation, or order issued thereunder by the Commission by any person who is registered or required to be registered under sections 4d, 4e, 4k, or 4m of this act or regulations promulgated by the Commission under this act, may elect, at any time within two years after the injury complained of occurs, to bring a civil action for damages in any district court of the United States. Any action under this subsection may be brought in the district in which the defendant resides or is an inhabitant or transacts business or wherein the act or omission complained of occurred.
>
> "(2) Any order of a district court awarding damages under paragraph 1 hereof shall be reviewable by the United States Court of Appeals for any circuit in which such action was brought in accordance with the provisions of subsection (g) of this section. Upon the failure of any person to satisfy any judgment of a district court awarding damages under paragraph 1 hereof within the period allowed for compliance or to take an appeal as herein authorized, he shall be subject to the penalty provided in subsection (h) of this section."

Sec. 106: To increase the dollar limitation on claims for which customers can arbitrate, sections 5a(11)(ii) and 17(b)(10)(ii) of the Commodity Exchange Act, as amended, are amended by deleting "$15,000" therefrom and inserting "$25,000" therefor. Sections 5a(11)(ii) and 17(b)(10)(ii) of the Commodity Exchange Act, as amended, are further amended by adding to the end thereof the following:

> ":Provided further, however, that the Commission may periodically adjust the limitation in subparagraph (ii) above to not exceed $50,000 to reflect changes in the Consumer Price Index, in the average amount of claims submitted to the Commission pursuant to section 14 of this act, and other pertinent factors."

Sec. 107: To authorize the Commission to disclose certain information to contract markets for market surveillance purposes, section 8a(6) of the Commodity Exchange Act, as amended, is further amended to read as follows:

> "(6) to communicate or routinely supply to the proper committee or officer of any contract market, notwithstanding the provisions of section 8 of this act, the full facts concerning any transaction, market positions, or market operation, including the names of parties thereto, which in the judgment of the Commission dis-

> rupts or tends to disrupt any market or is otherwise harmful or against the best interests of producers and consumers or which in the judgment of the Commission would facilitate surveillance of market activities by any contract market: Provided, however, any information furnished by the Commission under this subsection, either on an occasional or routine basis, shall not be disclosed by such contract market except in a self-regulatory action or proceeding."

Sec. 108: (a) Section 4f of the Commodity Exchange Act, as amended, is further amended by adding a new paragraph (3) to read as follows:

> "(3) The Commission may authorize a registered futures association to perform any portion of the registration functions under this section, in accordance with rules approved by the Commission, and subject to the provisions of this chapter applicable to registrations granted by the Commission."

(b) Section 4n of the Commodity Exchange Act, as amended, is further amended by adding a new subparagraph (7) to read as follows:

> "(7) The Commission may authorize a registered futures association to perform any portion of the registration functions under this section, in accordance with rules approved by the Commission, and subject to the provisions of this chapter applicable to registrations granted by the Commission."

(The following material was inserted by Neal P. Gillen, vice president and general counsel, American Cotton Shippers Association.)

COMMENTS OF THE AMERICAN COTTON SHIPPERS ASSOCIATION

INTRODUCTION

On October 30, 1980, the Chicago Board of Trade applied for designation as a contract market in medium-staple cotton for delivery in units of 50,000 pounds. In particular the Trading Conditions, Section XX36.01 made eligible for delivery specified grades of a staple greater than one and one-thirty second of an inch, and Section XX41.01 specified five delivery points: Galveston, Texas; Greenville, South Carolina; Houston, Texas; Memphis, Tennessee; and New Orleans, Louisiana.

On February 12, 1981, the Board of Trade submitted an amended application wherein Section XX36.01 made eligible for tender staple greater than one and one-sixteenth of an inch, and Section XX41.01 deleted New Orleans, Louisiana and added Bakersfield and Fresno, California, and Phoenix, Arizona as delivery points.

The amendments to the contract followed consultation by the Board of Trade with the Commission staff and the marketing cooperative which controls 47 percent of Arizona and California cotton, Calcot. At this important point in the development of the contract, the Board of Trade and the Commission staff choose not to consult with other members of the cotton trade, whose full participation is essential if the contract is to succeed.

On May 22, 1981 the Proposed Contract Market Rules as amended were published in the Federal Register, [1/] and the public was invited to comment.

These comments enumerate that in our judgment while the contract as originally proposed is viable and would be utilized by the cotton trade, the contract in its amended form is faulty, of doubtful commercial value because of its uncertainty and potential for manipulation, and that it will be short lived if approved in its present form.

INTEREST OF AMERICAN COTTON SHIPPERS ASSOCIATION

The American Cotton Shippers Association was founded in 1924 and is basically

---

[1/] 46 Fed. Reg. 27968 (1981).

comprised of merchants, shippers and exporters of raw cotton who are members of five federated associations, located in sixteen states throughout the cotton belt:

Arkansas-Missouri Cotton Trade Association
Atlantic Cotton Association
Southern Cotton Association
Texas Cotton Association
Western Cotton Shippers Association

The 525 Member firms of the ACSA handle over 80% of the domestic cotton crop and 90% of the export market. The Association takes an active part in promoting the increased use of cotton in the United States and throughout the world; establishes with other trade groups national and international rules and standards for trade, collaborates with cotton producer organizations in formulating production, research and promotion programs, and cooperates with government agencies in the administration of such programs.

The proposed contract is of major economic significance to our membership, involves the operations of the orderly transacting of the business of the membership to a substantial degree, and therefore our interest is manifest.

FUNCTION OF COTTON MERCHANT

Cotton merchants have a dual function of buying and selling cotton, including the assumption of the time, quality and price risks. The merchants purchase and assemble millions of individual bales of cotton offered for sale by approximately ninety thousand farmers producing cotton in sixteen states across the cotton belt. Over 18 varieties of U.S. cotton are produced in several hundred combinations of quality and staple lengths (due to the various types of seed, soil, weather conditions, and harvesting practices). The merchant classes each bale according to the quality factors and assembles the cotton of the same grade, staple length, color and character into even-running lots in warehouses at various locations in the different states. Cotton is sold to textile mills in spinners' markets in even-running lots at various times and delivery is made to locations designated by various textile mills. The merchant also performs the function of storing and concentrating cotton and the financing of surplus spot cotton including the excess ginnings over consumption during the major harvest months.

BACKGROUND OF THE ARGUMENT FOR WESTERN DELIVERY

The public record evinces the long standing advocacy of Calcot for delivery points in Phoenix, Bakersfield and Fresno. The recent inquiry by the Commission staff to the New York Cotton Exchange, for justification of its lack of western delivery points on the Number 2 Contract, is the latest example of Calcot's influence. The

Chicago Board of Trade submission of its contract application during Calcot's campaign to change the New York contract provided a political opportunity to appease Calcot who has, over the years, tried unsuccessfully to have delivery points added to the NYCE No. 2 Contract. This ecopolitical experiment strips the contract of its commercial utility by denying the entire cotton trade the essential functions of price discovery and hedging.

Soon after the CFTC was established in 1975, Calcot on October 3, [2/] petitioned the Commission requesting the establishment of delivery points at Phoenix, Bakersfield and Fresno. On October 17, [3/] the Commission responded stating that its authority was "limited to those cases where the contract market, after notification and a specified period of time to take action fails to make the rule changes which, in the opinion of the Commission, serve the above-mentioned purposes of assuring orderly markets." The Commission response indicated it had not "reviewed the adequacy of delivery points" on the NYCE Number 2 contract, "however, indications from past reviews . . . are that the Commission would not find that the current delivery points are insufficient to meet these purposes." The letter concluded that Calcot's "best course of action is to contact the New York Cotton Exchange and urge them to add one or more West Coast delivery points" or "approach one or more of the other Exchanges to determine whether they have any interest in becoming designated to trade in cotton with West Coast delivery points."

On November 3, [4/] Calcot responded taking the opportunity to inform the Commission that its economic situation justified the Commission exercising its authority to require a contract market to establish additional delivery points because of the abnormal movement of cotton in interestate commerce caused by the lack of western delivery points, claiming that the expense of moving cotton 2,000 miles for tender takes it out of its normal export market because this additional cost makes it noncompetitive for export from Gulf Coast ports. This rationale concluded with the assertion that since these circumstances diminish the desirability of delivery, the contract does not represent a true hedge.

The Commission responded on November 26 [5/] that "futures markets are not designed to serve as a substitute procurement and distribution alternative to the cash

---

[2/] Letter of G.L. Seitz, President, Calcot to Commodity Futures Trading Commission, Oct. 3, 1975.

[3/] Letter of Beverly J. Splane, Acting Executive Director, CFTC, to G.L. Seitz, Oct. 17, 1975.

[4/] Letter of G.L. Seitz to Beverly J. Splane, Nov. 3, 1975.

[5/] Letter of Anthony M. McDonald, Acting Executive Director, CFTC, to G.L. Seitz, Nov. 26, 1975.

markets. Rather, they were designed to facilitate cash marketing by means of providing a highly competitive forum for price determination and by provision of a medium for risk transfer through hedging." Concluding that the NYCE "clearly provides sufficient delivery points," Calcot was invited to join the public discussion of delivery by testifying before the Advisory Committee on the Economic Role of Futures Markets at its hearing on March 11, 1976.

On February 10, 1976, [6] Calcot wrote Commissioner Gary Seevers, Chairman of that Advisory Committee representing that it handled "approximately 40 percent" of the cotton grown in California and Arizona and stated that "our main point in recommending additional delivery points . . . is to prevent abnormal movement from the normal flow of cotton. In the two states that Calcot represents, our normal market is the export market and cotton moved out of Pacific Coast ports. On the average, the two states export something like 65 to 70 percent of the crop and in some years the Arizona crop is exported up to 90 to 95 percent."

On March 2, 1976, [7] Commissioner Seevers responded that the testimony at the Advisory Committee hearing in "Kansas City emphasized the view that futures markets should not be designed to function as cash market outlets" and that "several witnesses" (including Secretary of Agriculture John R. Block, then testifying for the Illinois Farm Bureau) "indicated that encouraging deliveries on a futures contract reduces its economic utility. Proliferation of delivery points could, therefore, run contrary to the purpose of the Act."

On March 1, 1977, [8] Cone Mills Corporation, a textile manufacturer in Greensboro, North Carolina, wrote Commission Chairman William T. Bagley of its opposition to delivery points in Arizona and California on the NYCE Number 2 Contract, noting that "we have never had any trouble obtaining space, when requested, at one or more of the existing delivery points." Noting that the contract would be weakened, Cone Mills asserted that "it would probably cost the producer money as Arizona points would encourage large amounts of Arizona cotton to be marketed on the contract." The letter concluded "that the contract is supposed to furnish price insurance rather than a marketplace for spot cotton."

On March 15, 1977 [9] the Commission's Chief Economist, Mark J. Powers

---

6/ Letter of G.L. Seitz to Commissioner Gary L. Seevers, Chairman, Advisory Committee on the Economic Role of Futures Markets, Feb. 10, 1976.

7/ Letter of Gary L. Seevers to G.L. Seitz, March 3, 1976.

8/ Letter of P.H. Davis, Vice President Cone Mills Corporation to CFTC Chairman William T. Bagley, March 1, 1977.

9/ Letter of Mark J. Powers, Chief Economist, CFTC to P.H. Davis, March 15, 1977.

responded that the NYCE "has submitted no proposals . . . nor is the Commission itself considering any such proposal." More importantly, Powers stated, "At the present time, CFTC is not aware of conditions which would necessitate the Commission requesting the New York Cotton Exchange to add delivery points to the Number 2 cotton contract."

THE DEBATE ON MULTIPLE DELIVERY POINTS, TESTIMONY AND RECOMMENDATIONS OF ADVISORY COMMITTEE ON ECONOMIC RULE OF FUTURES MARKETS

The issue of multiple delivery points was the object of public debate at hearings conducted in Kansas City, Kansas, in February 1976, by the Advisory Committee on the Economic Role of Futures Markets. Commissioner Gary L. Seevers, the Committee Chairman testified that:

> "An adequate delivery mechanism is a vital part — perhaps the most vital part — of preventing manipulation and market abuse. For that reason, Congress has given CFTC an oversight role in relation to futures exchanges, their delivery mechanisms and their delivery points.
>
> When Congress created the CFTC in 1974, it also amended the Commodity Exchange Act to read, in part:
>
>> 'each contract market shall...permit the delivery of any commodity, on contracts or sale thereof for future delivery, of such grade or grades, at such point or points and at such quality and locational price differentials as will tend to prevent or diminish price manipulation, market congestion, or the abnormal movement of such commodity in interstate commerce.'
>
> Only if the rules of a contract market do not meet these objectives, and the exchange fails to make necessary changes within 75 days after notification by the Commission, is the Commission authorized to order changes in these rules concerning deliveries.
>
> The Congressional intent is clear that the exchanges maintain initial responsibility regarding delivery specifications. This is entirely appropriate, given the many economic factors which must be considered in setting up delivery mechanisms. There must be that delicate balance, as always in futures contracts, between the interests of the longs and the interests of the shorts. Otherwise there will be no trading, no hedging, and no economic benefits to anyone.
>
> The government regulatory authority over delivery points is not really new. The Secretary of Agriculture had such authority before. However, the previous authority gave only one remedy — closing down the offending market. A more reasonable course of action is available to CFTC. The regulatory authority thus takes on a new meaning.
>
> The economics of this matter cannot be oversimplified, however, and the Commission has not yet developed a general policy regarding standards of sufficiency for delivery specifications. In an attempt to develop standards we are holding these hearings to solicit points of view concerning both commercial preferences and the adequacy of deliverable supplies. I might add that the Commission's Advisory Committee on the Economic Role of Contract Markets will also be studying the topic of delivery points and will be using the information gathered in this hearing. Some of the

> Committee members are here with us today.
>
> When futures contracts were born, in Chicago more than 100 years ago, there was not much question about delivery points. The normal flow of grain was from west to east by rail. Chicago was then the natural center of the cash market, and no other delivery point was really needed. Chicago had an adequate flow of the cash commodity, prices were representative, there was adequate delivery space, and no uncertainty for the long side of the contract.
>
> Today, we find a vastly different situation. More commodities have futures contracts and their marketing channels are often very diverse. With easily transported commodities like gold and treasury bills, delivery points present few problems. For imported commodities such as sugar and cocoa, we find few delivery point complaints. But with domestic commodities which tend to be bulky, perishable and/or seasonal, delivery points are very important indeed. For example, in grain today we find far more diversity in marketing channels than 100 years ago, and even 20 years ago. Grain now flows not only west to east, but north to south and even in some cases east to west like Nebraska feed grain to Colorado feedlots and soft wheat exported from the Pacific Northwest to the Orient. It is shipped not only by rail, but also by barge and truck. The terminal markets are declining, storage patterns are shifting and the whole system is decentralizing. Delivery point questions become far more difficult.
>
> Producers, especially farmers, have long felt they should have more delivery points. To some extent this reflects their feeling that their basis would be more consistent, perhaps narrower, with a delivery point close at hand. To some extent it may be due to the mistaken feeling that a futures contract delivery point represents an additional cash market outlet. This probably should not be the case, since delivery on futures is seldom as efficient for the marketing chain as regular cash market delivery. A contract with too high a percentage of deliveries may be in trouble. But the possibility of delivery must always be present for the markets to work well. The delivery point must certainly be adequate for that.
>
> On the other hand, longs would prefer a single delivery point. Then they are certain of the delivery location. If delivery is possible at three points, they can expect to get delivery at the least desirable of the three. It increases the complexity and uncertainty of doing business.
>
> The producer's concept of the ideal delivery point would be his farm gate. For the processor, it would be his loading dock. Neither side can achieve that ideal. A futures contract must normally be a realistic compromise.
>
> A contract structured to meet certain commercial needs may not provide adequate deliverable supplies. On the other hand, a contract written too broadly may offer so much uncertainty about the location of deliveries that commercial interests would be afraid to use it.
>
> The purpose of this hearing is to help the Commission develop a policy for effectively carrying out its oversight role in the interests of all." (emphasis supplied)

Among the producer representatives testifying was Secretary of Agriculture John R. Block, then appearing as an official of the Illinois Farm Bureau, who warned that:

> "Too many delivery points could prove damaging to the existing futures market operations. If this happens, all producers, including those using the new delivery points, would suffer. When an individual buys a contract, it is reasonable

> to assume that if he intends to take delivery he would like to know where the product will be delivered. Such buyers are not likely to buy if they fear delivery at some obscure out-of-position place for their operations. Since price relationships change frequently between markets, it is nearly impossible to arrive at a system of price differentials that is fair and equitable to all concerned."

Agricultural economists testified that a futures contract must have enough delivery capacity to prevent squeezes — but that adding more delivery points beyond the point of adequacy serves no useful purpose. In fact, they said, adding unneeded delivery points can threaten the usefulness of the contract by creating uncertainty for the long side of the contract. Commercial firms and speculators alike may then avoid using the contract — effectively killing it.

Dr. Tom Hieronymus of the University of Illinois testified that:

> "The delivery process must be kept as simple as possible. When delivery terms put speculators at a disadvantage they have a simple solution — they go away and trade something else. No speculator is tied to corn when there is a pork belly market. But a corn grower or corn merchant is tied to corn and he has to have speculators in his market."

Commercial hedgers generally opposed adding more delivery points. Robert Alexander of the Pillsbury Co. stated that:

> "The prime purpose behind the futures delivery option is to maintain the relationship between the cash and futures. It should never become a substitute for a cash market. Delivery should be structured so it remains a relative inconvenience rather than the most convenient way of marketing cash grain...."

Appearing for the Minneapolis Grain Exchange, Alvin Donahoo testified that an attempt to install added spring wheat delivery points at Portland and Seattle failed because of the cost of transportation. Noting that "if the holder of the warehouse receipt got delivery in Portland, but needed it in Minneapolis, the cost of the return movement would have been prohibitive. The contract would have lost all value as a hedging tool for the commercial interests in the Midwest, the East, or the South." An analogous situation would have a textile mill in South Carolina taking delivery in Fresno, California.

John Frazier testifying for the Chicago Board of Trade opined that:

> "Because no two delivery points have the same resale characteristics, the number of delivery points should be the minimum necessary to prevent squeezes and other abnormal price relationships. If delivery points permit shorts to deliver at a price better than the cash market, then the price level of futures contracts will fall to the level that will eliminate potential loss to the long at the most disadvantageous delivery point. This can result in substantial losses to producers. As a practical fact, multiple deliveries tend to make all users out-of-position hedgers with the possible exception of those few commercials that have facilities at each delivery point.

> The burden of proof should be squarely upon every proponent of a new delivery point that it can be included in the delivery system without disadvantaging the majority of market users."

Davis Anderson, economist for the Chicago Mercantile Exchange warned that political pressures must not be allowed to dictate delivery points or price differentials. Politics, he said, could destroy the balance between buyers and sellers in the markets, taking away the industry's ability to hedge. He said that with multiple delivery points, changes in local supply and demand conditions can dictate the futures prices for an entire industry. The only true test of delivery points and price differentials is whether they allow large numbers of hedgers to effectively use the futures market, he concluded.

The Kansas City Board of Trade testified that too-large deliveries had killed its corn futures contract, its feeder cattle contract, and its grain sorghum futures contract. Traders were not willing to risk being forced into taking large deliveries and simply stopped trading the contracts. "The distinction between cash marketing and futures marketing is not well understood," said KBOT President Chester Polson. "Many times when producers speak of delivery points 'near home' we fear they want to be able to sell futures as a cash marketing device. If a futures market is no more than a cash sales market, it will lose its ability to provide hedging protection. The proper system is for the producer to hedge for price protection — then sell his cash grain through normal market channels and lift his futures contract hedge. Actual deliveries should be somewhat inconvenient for both longs and shorts. Farmers overlook the fact that the current delivery point may be inconvenient for buyers as well. Why would a miller want wheat in Chicago or Kansas City if his plants are in the Southeast or Southwest? But the miller still hedges for price protection, just like the farmer."

Polson noted that "Multiple delivery points have many problems," some of which are:

> "(1) They will have a tendency to encourage deliveries on futures contracts resulting in the futures market becoming a cash commodity market; (2) they encourage deliveries by producers rather than the sale of their grain through normal market channels; (3) they will work to the disadvantage of the longs, who will not know at which point he will receive the delivery grain. Transportation from the delivery point to the point of the end-user or exporter is a very important factor. (4) Shortage of transportation or market congestion is often mentioned as a reason for needing multiple delivery points. Is not this a problem of the cash market rather than the futures market? Will not this make possible a much larger percentage of commodities delivered on futures contracts? If a large quantity is delivered on futures contracts, the liquidity of the futures market will be affected. This will tend to make a cash market out of a futures market.
>
> A larger number of delivery points to make it more convenient during transportation shortages for producers and others to make deliveries would in no way help the situation. A short forcing deliveries on a long at multiple delivery points because

> of transportation shortage or congestion does not help the situation. He only transfers the problem to the long. This does not help the transportation problem. Multiple delivery points can set up many more conditions in a futures market where price manipulation can occur, and actually solve no transportation or congestion problems. The key to any market is transportation — the ability to move the commodity from the point of production to the point of storage or to the end-user or exporter."

The classic failure of a multiple delivery point contract was the Kansas City Gulf Futures Contract for hard winter wheat with 10 interior delivery points with settlement price basis delivered the Gulf for export. In explaining the failure of the contract Polson explained that:

> "The gulf futures market did not have acceptance from the trade. There were mixed feelings between the exporters where it had to have acceptance if it was to succeed. There were many problems with the contract, some of which were:
>
> 1. The contract was an export-oriented contract which could not fill the needs of the mills or domestic users. A mill could not satisfactorily use it for a price protection hedge as it did not relate to his location or operations. Values were different and all points did not have the same transportation or economic value except on direct Gulf export sales.
>
> 2. It would have become a cash market. Elevators with large stocks of wheat during periods of transportation shortage, low quality factors, interest cost and storage cost, would have forced deliveries. Exporters who would be the longs would acquire stocks on which they had very little control over shipments or quality to meet their export needs. Exporters do not have large storage facilities at Gulf points; therefore, they would have had a serious logistical problem. They experienced this same problem during the days of large stocks supplied by Commodity Credit Corporation over which they had very little control.
>
> 3. We already had a cash export market based on the current contract where the buyer and seller agreed on the necessary quality factors and delivery terms at the time of the trade. Exporters need wheat every month rather than once every three months.
>
> 4. The Kansas City market is primarily a hedging market - - 90% hedge and 10% speculative — which resulted in not having enough speculators to take up the slack periods to maintain market liquidity in two wheat contracts.
>
> 5. The new Gulf export contract took away from the original contract to the extent that we would have had two weak contract markets instead of one strong market.
>
> There also were other factors; however, we feel the main overall reason for its failure was having too many approved regular delivery points and warehouses which was only replacing the established cash market system.
>
> It was a good example of what happens when the market rules and regulations get out of balance in favor of one side of the market."

The Advisory Committee released its report on June 17, 1976, opining that it "believes that a commodity futures exchange is not a direct link in a physical distribution system for a commodity, but rather an auxiliary institution designed to enhance the working of the physical marketing system."

More specifically, the Committee recommendations on the number and location of delivery points noted that "these specifications are central to both the commercial utility of the contract and its susceptibility to manipulation or congestion," and:

> "For other commodities that are not easily transported, more than one delivery point may be needed to insure sufficient deliverable supplies. However, this should be done only after careful consideration is given to other types of delivery solutions, and to maintaining or achieving a careful balance between the interests of the buyers and sellers who may become involved in the delivery process. Depending upon the locational differentials, the most desirable delivery location or locations would:
>
> (1) Reflect the economic value at the market location most important to the mainstream of the commercial trade.
>
> (2) Minimize uncertainty to the long (since in most cases the short has the option of choosing the delivery location); this encourages the long to participate in the contract, and avoids discounting the futures price to reflect the cost of the uncertainty.
>
> (3) Minimize the incentive to liquidate by delivery.

In summary, the Committee makes the following recommendations concerning delivery point numbers and locations:

> 1. The contract must provide sufficient delivery capability to facilitate price convergence in the delivery month of the commodity's cash and futures markets without distortion.
>
> 2. Delivery points should not be added or changed unless this is necessary either to permit sufficient delivery capability or to significantly increase the net economic benefits of the contract.
>
> 3. The delivery point or points should be located at the markets for which prices are most important to those interests which use the contract or could be expected to use the contract. If delivery points are to be added or changed, it should be to significantly increase the net economic benefits of the contract. However, the possibility of continued use by those currently using the contract must also be considered.
>
> 4. The exchanges and industry groups should constantly monitor the delivery points to assure their adequacy for effective hedging and price formation."

ADEQUACY OF EXISTING DELIVERY POINTS ON NYCE NO. 2 COTTON CONTRACT DEMONSTRATES SUFFICIENCY OF DELIVERY POINTS ORIGINALLY PROPOSED BY CBT MEDIUM STAPLE COTTON FUTURES CONTRACT

On November 13, 1980, [10] the Commission's Chief Economist James A. Culver in a letter to the New York Cotton Exchange, raised the issue, inter alia, of the adequacy of delivery points on the NYCE No. 2 Contract.

In the period following the 1977 response by Chief Economist Powers and the 1980 inquiry of Chief Economist Culver the number of contracts traded on the New York contract increased from 826,395 to 2,490,405. Within this time frame Calcot continued its effort to change the New York contract in meetings with the New York Cotton Exchange and Members of the Commission and its staff, no doubt impelled by its poor performance in the marketplace.

Despite the success of the NYCE No. 2 Contract and its proven value to commercial trading interest in the Far West, Chief Economist Culver opined in his letter that:

> "The Commission's staff believes the cotton no. 2 contract is essentially a Midsouth contract. Production of tenderable cotton, however, has continued to shift from the Southeast and Midsouth to Texas and the western states. Although much of this increased production has taken place in Arizona and California, there is no western delivery point. For a number of reasons western cotton has not normally been tendered on the current contract. Western cotton frequently trades at a premium to Memphis territory cotton, and the costs and time involved in shipping western cotton to one of the current delivery points are substantial.
>
> In several recent liquidations of expiring cotton futures, supplies of tenderable cotton in the Midsouth were very scarce. While tenderable cotton was available in the West, frequently at prices below those prevailing in Memphis, the time and costs involved in shipping that cotton east to a designated delivery point substantially limited the quantity of such cotton that could be delivered economically. Although some cotton was shipped east to delivery points, apparently it was transported to those points for the sole purpose of making delivery on the contract rather than to satisfy a commercial demand.
>
> In view of the considerations outlined above and the Commission's belief that the liquidations of several recent cotton futures contracts have exhibited congestion, the Exchange should demonstrate that the current delivery provisions of the cotton No. 2 contract result in a deliverable supply of cotton sufficient to comply with the requirements of Sections 5(d) and 5a(10) of the Act. The report should specifically address the possible need for additional delivery points and the conditions that should apply to deliveries at any such additional points."

---

[10] Letter of James A. Culver, Chief Economist & Director, Division of Economics and Education to J. William Donaghy, President, New York Cotton Exchange, Nov. 12, 1980.

The NYCE responded [11] to the questions raised by the CFTC Chief Economist inquiring:

> "Would more delivery points increase the amount of cotton available for delivery on exchange contract?
>
> The cotton industry, like most large industries, has four basic segments: production, transportation, manufacturing and marketing. The producers and manufacturers (i.e., the growers and mills) use the futures markets to reduce the risks of price fluctuations by hedging. Merchants act as intermediaries between growers and mills and, for their own account, buy from the growers and sell to the mills and also hedge on the futures market because they assume price risks. A grower's crop will find its way to a mill in the United States, directly or through a merchant, or to a seaport for export to a mill abroad, directly or through a merchant.
>
> If there were no futures market the crop of a grower in California or Mississippi would be transported to a seaport or mill. With a futures market the same thing happens, but an insignificant amount of grown cotton is delivered on a futures contract.
>
> Of course all cotton is not tenderable on the futures contract. About half the cotton grown is tenderable. However, a comparison of tenderable cotton with deliveries on futures contracts will still show an insignificant percentage of deliveries.
>
> Of more relevance to our inquiry is the comperison of the number of futures contracts traded in relation to deliveries. The percentage of contracts delivered in relation to contracts traded is so small as to almost reach the ideal of no deliveries. During the five-year period 1976-1980 the percentage of deliveries to contracts traded was .17% as shown by the following table.

	Contracts Traded	Contracts Delivered	
1980	2,490,405	3,255	0.13%
1979	1,690,051	2,451	0.15%
1978	1,155,801	2,274	0.20%
1977	826,395	1,894	0.23%
1976	969,348	2,122	0.22%
	7,132,000	11,996	0.17%

> The actual amount of cotton delivered is far less than the figures shown. During a single maturing month, the same cotton is redelivered a number of times. And even as to different months there are deliveries of the same cotton as for example when a receiver of May cotton delivers that cotton on the July contract and when that cotton is again delivered on the October contract. When these multiple deliveries are considered, the figure of .0017 of deliveries begins to approach the vanishing point.
>
> The Exchange has five delivery points, three of which are so located as to facilitate export by merchants: Houston, Galveston and New Orleans; and two of which are located in reasonable proximity to mills: Memphis and Greenville.
>
> . . . . .

---

[11] Letter of J. William Donaghy to James A. Culver, April 28, 1981.

If a California point were established for delivery on Exchange contracts, the grower in California would continue to ship practically all of his cotton in commercial transactions to a port in California for export or to a mill in the Southeast for manufacturing. To the extent that he made deliveries on the Exchange, he would have the choice of delivering an insignificant amount of cotton to six points rather than five.

The present delivery points permit receivers to export the cotton or send it to a mill. But the taking of delivery can rarely fit into commercial plans of the receiver. The deliverer has the right to select the delivery point and the grade and staple of the cotton delivered within permissible grades and staples. Thus a receiver who wishes to sell long staple cotton to a mill in Greenville is not well served if he takes delivery and receives short staple cotton in Galveston; and a receiver who wishes to fulfill a contract to sell short staple cotton to China is not helped by taking delivery of long staple cotton in Memphis.

Futures contracts provide for delivery because at the time they were first regulated it was considered gambling for one party to pay money to another based upon a fortuitous event and all forms of gambling were regarded as evil and punishable by statute. The gambling element was removed from futures contracts by the preservation of the requirement that each party make or take delivery if his contract is not liquidated by offset prior to its expiration. However the use of a futures contract to make or take delivery is rare.

We doubt that it can be shown that the establishment of a delivery point in California would result in any significant amount of additional deliveries under our contract.

We do however see new problems if additional delivery points were designated in a large growing area. That might encourage deliveries.

It is the view of some students of the futures industry that a perfect futures market would be one on which no deliveries take place. Recognizing that under the presently accepted theory underlying the legality of futures markets, the right to take or make delivery must remain inviolate, the question is raised whether deliveries should be encouraged or discouraged. A hedger, for whose benefit the futures market has been allowed to exist, can derive his full protection by liquidating his position before the contract expires. It is the failure of the hedger and speculator to liquidate before expiration that causes the problems which your inquiry seeks to have resolved. It seems to us that the establishment of an additional delivery point would exacerbate those problems if it encouraged deliveries."

"Are congestions on the New York Cotton Exchange brought about by the insufficiency of deliverable supply?

We are not at all convinced that a congestion on this Exchange is the result of a shortage of deliverable supply. It is our experience that congestions result from the overstaying in the market by speculative shorts and obstinate longs (a) who find that their estimates as to how the price will move have been wrong and who wish to reduce their losses, or, (b) who wish to increase their gains by technical market forces. The number of contracts involved in congestions have been too small to attribute congestions to the shortness of supply.

The cotton contract has certain features not provided for in futures contracts generally which are designed to avoid the adverse effects of a congestion. Deliveries may be made during the month beginning five business days from first

> notice day (which is the first business day in the month) to six business days from the end of the month and ten business days after the close of trading. By-Laws, Sec. 9.03(2). Certificated cotton need not be tendered at the time of delivery. Sec. 9.03(26)(a). Under the Cotton Futures Act the deliverer is permitted to furnish to the receiver either a certificate of grade or a notice of grade of each bale to be delivered. Sec. (f)(1)(F). Where cotton is to be delivered without having been classed and certified by the U.S. Department of Agriculture at the time of delivery, provision is made for the handling of such delayed certification. Regulations of the Department of Agriculture for Cotton Classification under the Cotton Futures Legislation, Secs. 27.52-27.56. This procedure is referred to as delivery of cotton under 'deliverer's class.'
>
> thus it is error to assume that the available supply of cotton is the amount of the certificated stock. And it should be noted that a substantial amount of cotton is delivered on deliverer's class."
>
> "Would additional delivery points decrease the potential for manipulation?
>
> It is our view that the amendment to our contract to establish an additional delivery point is not required to comply with Sec. 5(d). This is so apart from the points made above that an additional delivery point will not increase deliverable supply and that increased supply will not reduce congestions. The avoidance of manipulation lies not in having six instead of five delivery points but in the ability and experience of an exchange to deal with congestions. That we have such ability and experience is demonstrated by our success in resolving congestions to the end that our record on preventing manipulations is exemplary."

The NYCE notes that in a few "rare" instances "it has been contended that manipulation has occurred." The most recent cases, Volkart in 1957 and Hohenberg in 1971, found the traders not to have manipulated or attempted to manipulate the contract. It was only in the case of Plains' Cotton Cooperative Association in 1972, that the allegations of manipulation were not contested. Here, the cooperative entered into a settlement in which the Commission issued a finding that Plains had manipulated the prices of the May and July 1972 cotton futures contract in willful violation of the Commodity Exchange Act.

> "Will the establishment of a western delivery point make it easier to manipulate prices?
>
> A substantial amount of cotton grown in California and Arizona is controlled by a large cooperative association of growers. In addition, a single family owned operation in that area produces more cotton than any other single farm in the world. The designation of a delivery point near this area would give to these giants the facility to certificate cotton for delivery or to decertificate cotton previously certificated.
>
> The power of one or two groups to cause a large amount of certificated stock to hover over the market can have an artificially depressing effect on the futures price by causing longs who do not want delivery to sell. Conversely the decertification of large amounts of certificated cotton can have the effect of artificially increasing the futures price

> since it amounts to an announcement to the industry of an intention of withholding such stock from delivery.
>
> The establishment of a delivery point in such places as Fresno or Phoenix could increase the danger of manipulation to a far greater extent than that existing in the industry today where delivery points are so located that they are not easily amenable to group control of enormous amounts of cotton.
>
> The Advisory Committee Report on Economic Role of Contract Markets discussed certain characteristics of delivery points as being important including the following:
>
>> Public access to delivery and storage facilities to the extent practical. (Ownership patterns and operating practices which might tend to reduce public access should be avoided.)
>>
>> Access to a cash market where deliveries can be resold at an economic price without discrimination or disadvantage to recipients. . . .
>
> In determining whether a western delivery point would be advisable, consideration should be given to the points raised by the Advisory Committee Report."

Finally, the Commission requested that the NYCE demonstrate that the current delivery provisions result in a deliverable supply of cotton sufficient to comply with the requirements of Sec. 5(a)(10) which requires a contract market to:

> "permit the delivery of any commodity, on contracts of sale thereof for future delivery, of such grade or grades, at such point or points and at such quality and locational differentials as will tend to prevent or diminish price manipulation, market congestion, or the abnormal movement of such commodity in interstate commerce."

The Exchange responded that:

> "We can safely say that there is no abnormal cotton movement in interstate commerce by reason of our delivery requirements. The Director's letter states that western cotton has not normally been tendered on the contract. The amount of cotton delivered on contract from western states under the present rules is small in relation to total deliveries on contract. The establishment of a western delivery point may well tend to increase the amount of cotton delivered on contract in interstate commerce."

Given the proven adequacy of delivery points on the NYCE contract the CBT contract as originally submitted, without Western delivery, should be approved for the reasons effectively presented by the NYCE in its response to the Commission.

SURVEY SHOWS THAT COTTON MERCHANTS UTILIZING FUTURES MARKET TO HEDGE FIXED PRICE PURCHASES AND SALES WILL NOT UTILIZE CBT MEDIUM STAPLE CONTRACT WITH WESTERN DELIVERY

Prior to the May 22, 1981, publication of the Proposed Contract Market Rules, the great majority of the Association's membership, particularly the small and medium sized firms, had no previous knowledge of the CBT Medium Staple Cotton Futures Contract. The Association mailed copies of the contract to the membership and prepared a survey [12] to determine if the contract was commercially viable. The survey responses show conclusively that the contract in its amended form will not be utilized by the cotton trade.

The survey questions and the responses noted the following:

A. Do you think that the differences in the CBT contract would allow you to utilize the contract for

	YES	NO	UND*
—Price discovery?	9	34	3
—Adequate hedge against fixed price sales to mills or others?	7	38	1
—Adequate hedge against fixed price purchase from farmers or others?	9	35	2

B. Do you think that delivery points in cash market locations (Phoenix, Bakersfield & Fresno) will

	YES	NO	UND
--increase likelihood of deliveries?	37	8	1
—serve as an alternative cash market?	31	12	3
—increase potential for manipulation?	32	10	4

C. Do you think that your inability to tender 1 1/32" when 1 1/16" is in short supply removes an essential safety valve from the contract?

YES	NO	UND
36	9	1

D. Given the essential differences in the existing NYCE Number 2 contract and the proposed Chicago contract, our firm would make principal use of the

NYCE Number 2 43 CBT medium staple 1
Undecided 2

E. Given that the New Orleans and Chicago contracts prohibit the interchange of NYCE Number 2 tender certificates, do you favor making tender certificates interchangeable on all exchanges?

YES	NO	UND
18	26	2

F. Would you be deterred from using the Chicago contract on the "buy" side given that the seller can deliver at Western points or at the Traditional NYCE Number 2 delivery points?

YES	NO	UND
35	10	1

---

[12] The survey questionnaire was accompanied by a letter explaining the essential differences in the NYCE No. 2 contract and the CBT Medium Staple Contract. The survey was mailed to all active members and those firms responding account for no less than 80% of the cotton merchandised in the U.S.

*Undecided.

The faults inherent in the amended CBT contract deny it commercial utility and render it useless to the firms, responding to the survey, who merchandise no less than 80% of the U.S. cotton crop. Therefore, the success of the contract is absolutely dependent on its utilization by these firms.

DOMINANT POSITION OF CALCOT AND FEW LARGE PRODUCERS IN ARIZONA AND CALIFORNIA WILL DISCOURAGE HEDGING, PRECLUDES ACCURATE PRICE DISCOVERY AND POSES POTENTIAL FOR MANIPULATION

"Each futures contract is reviewed by CFTC economists and trading experts to confirm that it offers the best possible terms for trading, serves an economic purpose, and is not contrary to the public interest." This is how the CFTC describes part of its role in a recent publication, "Economic Purposes of Futures Trading." It concludes noting that "the CFTC responsibility might best be summarized by saying that its purpose is to ensure fair practice and honest dealing in futures trading, permitting accurate price discovery and opportunities for efficient hedging through competitive manipulation-free markets." The results of the ACSA survey and analysis of the cotton futures market clearly indicate that these factors are lacking in the amended CBT contract. By suggesting that the CBT add delivery points at cash market locations, dominated by a producer cooperative controlling a minimum of 45% of the production and by a small number of large producers controlling another 17%, the CFTC staff has precluded the CBT medium staple contract from meeting the standards cited above.

Unless the proponents prove that additional delivery points can be added to the contract without placing the majority of market users at a disadvantage, the Commission should not approve the contract in its amended form, given that Phoenix, Bakersfield and Fresno preclude accurate price discovery, eliminate opportunities for efficient hedging, and hold the potential for manipulative practices.

Market Dominance of Calcot and Large Producers

In 1979 Calcot handled 2.2 million bales, controlling 47% of the Arizona-California crop, and in 1980 it handled 1.9 million bales, controlling 43% of these crops.

The other dominant factors in 1980 were five California land owners, who produced 400,000 bales or 13% of the California production. Another 25 producers in California accounted for 250,000 bales or 8% of the California crop. 13/ In Arizona in 1980, four land owners produced 117,000 bales or 9% of the crop. In the aggregate, these giants controlled 60% of the Arizona/California crop in 1980.

13/ Getting Bigger, Large Scale Farming in California, California Institute for Rural Studies, 1980.

Potential for Price Manipulation

An examination of the form G loan entries for California and Arizona [14] indicates that western delivery points will make it possible for Calcot and other large producers or merchants who own and control their own warehouses to certificate cotton futures market and the spot price.

The act of decertification could have the opposite effect — increasing prices in the futures market and the spot price. Great uncertainty would prevail in the market. This uncertainty will discourage public participation in the market — participation necessary for liquidity and the proper functioning of the market.

It is not in the public interest to have a contract subject to the possible influence and dominance of large controlling participants in a particular location.

Western Delivery Points Could Serve as Spot Markets

The futures market was not designed to serve as a spot market. The essential and primary functions of price discovery and hedging cannot be accomplished if the contract permits it to act as a spot market.

Calcot has interior warehouse capacity to store 250,000 bales in Arizona and 1,375,000 bales in California. This represents 32% of the Arizona warehouse capacity and 66% of the California capacity. The ability to store cotton in its own warehouses, to certificate or decertificate stocks, and to maintain stocks at interest rates [15] substantially lower than current commercial rates increases the likelihood that, in situations when demand is weak and supplies are large, the less desirable qualities could be dumped onto the market through the certification process. The CBT contract could become the spot market for Calcot.

Potential for Congestion

If large certified stocks are created at Western interior warehouses, the value of the contract could diminish due to the fact that these warehouses are extremely congested during harvest time. The inability to move cotton on the contract in an orderly manner, during the harvest months, will adversely influence prices.

The CBT contract as proposed without western delivery points will allow for irrigated and rain grown cottons to efficiently find their way towards delivery, with no area of the cotton belt provided the convenience of delivery at their farm gates.

---

[14] Currently Calcot has approximately 425,000 bales of 1980 cotton in the CCC loan. The attached tables illustrate that at peak months in 1980 Calcot had under loan 26% of the Arizona/California crop and 11% of the total U.S. crop.

[15] The CCC interest rate for the 1980 crop is 11.5% and for the 1981 crop it is 14.5%.

UPLAND COTTON: Form G Loan Entries by Months in Arizona and California
1966-1979

	AUGUST	SEPTEMBER	OCTOBER	NOVEMBER	DECEMBER	JANUARY	FEBRUARY	MARCH	APRIL	MAY
ARIZONA	-									
1966	-	0	0	39,202	29,838	28,878	3,155	474	461	0
1967	-	0	11,005	31,231	8,319	16,826	8,655	0	4,495	4,089
1968	-	0	0	51,214	77,628	89,786	26,138	3,445	813	176
1969	-	0	14,624	52,182	53,710	75,071	17,564	3,384	11	63
1970	-	0	14,013	30,603	44,043	31,615	2,108	438	515	131
1971	0	0	5,791	43,787	39,272	19,762	15,755	3,341	0	0
1972	-	0	10,132	24,904	61,272	46,517	16,913	5,689	446	538
1973	-	0	14,810	43,158	34,156	37,053	7,110	3,304	217	95
1974	-	0	25,504	57,609	59,365	81,059	9,199	0	30,590	2,411
1975	-	-	0	758	0	37,013	0	0	0	0
1976	-	-	-	-	-	2,292	0	0	0	122,682
1977	-	-	-	82,026	84,390	69,395	22,946	10,208	3,929	229
1978	-	-	-	1,653	16,337	27,746	16,189	16,426	5,003	45
1979	-	-	-	55,977	55,732	78,309	52,141	15,975	9,782	2,916
1980	-	-	-	65,532	70,736	164,978	72,731	82,800	5,484	7,831
CALIFORNIA										
1966	-	0	0	171,912	39,614	75,042	13,902	1,662	177	0
1967	-	0	2,028	63,245	31,809	102,200	66,326	0	13	22
1968	-	0	10,833	105,086	174,157	224,580	88,315	28,191	14,168	6,686
1969	-	0	38,133	191,543	107,488	109,364	36,730	4,416	3,598	683
1970	-	0	24,861	203,444	86,879	103,998	9,690	993	0	304
1971	0	0	18,155	149,777	97,631	97,063	11,801	1,141	0	0
1972	-	0	84,495	164,269	113,692	146,946	18,610	3,181	291	2,399
1973	-	0	97,960	300,222	151,638	66,705	16,862	4,524	389	393
1974	-	0	138,663	253,017	301,561	123,999	31,812	0	35,375	13,418
1975	-	-	0	39,990	0	71,049	0	0	0	0
1976	-	-	-	-	0	0	0	0	368,854	61,661
1977	-	-	9,017	222,365	292,326	251,440	51,813	25,574	7,978	5,671
1978	-	-	-	10,864	77,698	136,557	29,061	18,518	10,726	0
1979	0	0	6,799	187,382	170,558	188,182	144,567	42,061	14,221	10,151
1980	-	-	-	239,369	319,838	508,817	144,435	103,064	4,118	5,262

Calcot Stocks* in CCC Loan - 1976-1980

	Oct.	Nov.	Dec.	Jan.	Feb.	March	April	May	Total State Crop	Calcot % Total State Crop	Total U.S. Crop	Calcot % Total U.S. Crop
1980 Aris	-	65,532	100,385	208,939	244,796	283,603**	256,838	223,046	1,354,000	21%		
Cal.	-	236,369	526,065	840,245	893,136**	854,067	722,682	573,355	3,109,000	29%		
Total	-	301,901	626,450	1,049,184	1,137,932	1,137,670	979,520	796,431	4,463,000	26%	11,018,000	11%
1979 Aris	10,482	44,257	74,642	131,299	163,710**	156,573	142,400	123,113	1,280,000	13%		
Cal.	6,789	170,626	279,347	414,428	507,038**	479,229	454,755	423,861	3,408,000	15%		
Total	17,271	214,883	353,989	545,727	670,748	635,852	597,155	546,974	4,688,000	14%	14,531,000	5%
1978 Aris	-	1,653	24,145	36,104	45,133	58,198**	56,476	42,076	1,068,000	5%		
Cal.	-	10,864	115,867	179,939**	174,353	167,375	152,290	121,012	1,940,000	9%		
Total	-	12,517	140,012	216,043	219,486	225,573	208,766	163,088	3,008,000	8%	10,762,000	2%
1977 Aris	-	57,534	117,528	138,825**	137,884	122,850	99,124	79,956	1,070,000	13%		
Cal.	8,978	192,397	421,597	585,202**	540,702	508,316	385,441	280,879	2,790,000	21%		
Total	8,978	249,931	539,125	724,027	678,586	631,166	484,565	360,835	3,860,000	19%	14,277,000	5%
1976 Aris	-	-	-	2,292	2,292	-	-	109,217**	834,000	13%		
Cal.	-	-	-	*	-	-	368,854**	336,904	2,482,000	15%		
Total	-	-	-	2,292	2,292	-	368,854	446,121	3,316,000	14%	10,517,000	5%

* Source - ASCS, USDA - Monthly stocks show a net position reflecting loan repayments

** Combining totals showing highest level of monthly stocks

* * *

By including Western Delivery, the contract will be denied the sufficient open interest necessary to facilitate price discovery and hedging — the contract is likely to fail.

For the reasons enumerated above, we recommend that the Commission not approve the contract in its amended form. The Commission should approve the contract as originally submitted and allow the Chicago Board of Trade the competition it desires with the New York Cotton Exchange.

Respectfully submitted,

Neal P. Gillen
Vice President &
General Counsel

ANALYSIS OF THE CHICAGO BOARD OF TRADE COTTON FUTURES CONTRACT PROPOSAL

PROFESSOR ROGER W. GRAY
FOOD RESEARCH INSTITUTE
STANFORD UNIVERSITY

ANALYSIS OF THE CHICAGO BOARD OF TRADE COTTON FUTURES CONTRACT PROPOSAL

HISTORICAL BACKGROUND:

The cotton futures contract proposal which the Chicago Board of Trade (CBOT) has submitted to the Commodity Futures Trading Commission (CFTC) needs to be placed in historical perspective, both long-term and recent. The issues which it raises or reflects are complex and controversial, but they are not new excepting as to their particular manifestations in this instance -- the underlying issues are longstanding. The design of delivery specifications for a commodity futures contract, especially as regards grade and quality characteristics and differentials, and delivery locations and differentials, is made simpler by uniformity of commodity quality and uniformity of movement flow and carrier mode. But it becomes immensely more complicated as different qualities are produced in disparate production areas and shipped in different directions by a variety of modes. From a practical standpoint, the proof of the pudding is in the eating. The interests of exchange members and users, and the public interest, are best served by a contract which attracts the largest participation by buyers and sellers on a continuing basis. Wide participation by commercial buying and selling interests, as well as active speculation to make a continuous market, affords the best assurance of accurate price discovery and adequate hedging opportunity. The delicate balance between buyers and sellers, however, or among different buyers and different sellers, is an ever shifting balance. Supply and demand from various areas and for various qualities can change abruptly, or gradually over the years. Different buyers and sellers will be affected differently -- some will perceive and adapt to the changes, while others will not. The point at which the futures contract itself needs revision is not easy to determine in these inherently dynamic conditions.

Let us consider briefly two situations, neither involving cotton, which illustrate the problem, before considering some history involving cotton. The 1960 soybean crop was below normal and was underpriced early in the harvest season. Speculators bought futures, and as the perception of shortage grew so did speculative buying, until ultimately prices were carried too high and a sharp correction came late in the spring of 1961. Some major soybean crushers, following their usual hedging practices, lost heavily during this period. They blamed the futures market and called for reforms, and the Soybean Digest criticized the market editorially. Other major crushers, however, adapted their hedging strategies to the new situation and weathered the storm. An underlying problem was that soybean futures was "the only game in town" in 1960. Some two-thirds of all futures trading in the United States was in the soybean complex that year. There were no livestock contracts, no precious metals contracts, no financial instruments contracts, whereas the traditional grain and cotton contracts had been victimized by the government loan programs -- wheat and corn were barely trading and the cotton futures market was virtually moribund. Speculators who wanted any play at all had to look to soybeans: through no fault of the contract, nor of the Commodity Exchange Authority, nor of the CBOT, too many speculators bought soybean futures.

Consider in contrast the oats futures situation at the CBOT, where throughout the 1960's the open interest dwindled rapidly. This decline came in somewhat belated reflection of the fact that oats production had moved northward from the corn belt (as soybean production displaced oats) and oats movement came to be centered upon Minneapolis, mainly bypassing Chicago. Meanwhile the Chicago delivery provision became an increasingly strong deterrent to hedging Minneapolis stocks -- not because the basis was erratic or unpredictable as has been alleged by some cotton interests vis-a-vis the #2 contract, but because the basis regularly and predictably worked against the hedge of Minneapolis stocks in Chicago futures. The solution was obviously a Minneapolis delivery, but a partial solution of Minneapolis or Chicago at a difference was adopted.[1]

The foregoing are but two of many instances of perceived difficulties with futures markets, some of which, as with the oats contract, indicated the need for contract revision, while others (soybeans) did not. Some implications of such examples may be drawn. (1) It would not have been easy to tell, when the first complaint came from the first user who abandoned the oats contract, whether there was a contract problem requiring a remedy or a disgruntled user who had misjudged a market. (2) If, in the course of time (or even suddenly, as in the case of Kansas City Wheat Futures in 1953), there is a decline in open interest reflecting widespread abandonment of the market, this would tend to indicate need for contract revision (true of both oats and Kansas City wheat at the time). If open interest is steady or rising rapidly, as with the current #2 cotton contract,[2] complaint from one user more likely reflects market misjudgments. (3) The belief that adding delivery points for the convenience of those who feel adversely affected by basis changes will solve the problem is something of a chimera. When real changes occur in the price relationships between areas and qualities, as they do in cotton, the futures market cannot and should not alter this fact. In the past decade Memphis and California SLM 1 1/16" have differed over a range of some 1200 points, whereas in three successive years California went from a discount of 100 points (1972) to a premium of over 800 points (1973) back to a discount of over 100 points (1974). Deliverability in California wouldn't change this relationship. It would simply bring the futures price down to the California level in years of low California prices and down to the Memphis level in years of low Memphis prices. This is what happens in the present situation; with California cotton deliverable against the N.Y. #2 contract, in years of low California prices (1972 and 1976 especially) large amounts of California cotton were certified for Memphis delivery. This is a quite different matter from the emergence of a persistent bias against a hedge of the majority of stocks, as developed in the oats market.

---

[1] Both the soybean and oats episodes are more fully documented in unpublished papers of mine, which could be supplied to the Commission on request.

BRIEF HISTORY AS REGARDS COTTON:

Probably the earliest official study and documentation of a delivery location problem is found in the Federal Trade

---

[2] Note - The recent decline in the open interest in the NYCE #2 contract reflects the lack of interest of speculators due to falling prices and high interest rates

Commission (FTC) Report on The Cotton Trade (1924). This report contained the recommendation "that some form of southern delivery on New York contracts should be adopted and . . . that Congress enact legislation to that end." (P. 241) The result has been that the only futures contract having some of its provisions specifically required by legislation has been that for cotton. (Some provisions applicable to other futures contracts, such as the 7-day delivery rule adopted in 1938, came as regulations issued under the Commodity Exchange Act.) The FTC study showed in historical perspective that New York City had become an out-of-position location for deliveries against cotton futures contracts. The textile industry had moved south, and cotton exports to Europe via New York had diminished. The situation resembled that which emerged in oats some decades later. A feature of the act provided that grade differentials be established on a commercial basis with reference to spot market prices; in contrast to the provision in grain futures for fixed differentials stated in the contracts.

The southern delivery contract for New York futures flourished for more than two decades. Prior to disastrous impact of the government loan program upon cotton futures trading, the cotton futures market had become the largest and best balanced of any futures markets -- it had the largest open interest in terms of contract values and had the most nearly balanced usage by short and long hedgers. For a twenty-year period from the early 1950's to the early 1970's, however, cotton futures trading ranged between inactive and non-existent. By the time agricultural policies changed back to a market orientation, exports became buoyant, and government owned stocks were disposed of, the revival of futures trading was not as prompt as many hoped. Floor traders had since retired, died or turned to other occupations; a new generation of mill buyers had never used futures, merchandising firms had become warehouses storing C.C.C. cotton for fixed prices, and cotton production had undergone geographic and technological change. Under these circumstances market revival came slowly, users or potential users complained that the market was thin and executions were poor -- circumstances that can only be alleviated by more trading. A vicious circle wherein no one will trade because the market is thin, and the market is thin because no one will trade, can only be broken by more trading. Only in recent years does it appear that the circle has indeed been broken. Month-end open interest which had first exceeded 20,000 contracts (during the modern revival) in April, 1971, then stagnated and did not again exceed 20,000 contracts until February, 1976. Since then, however, growth has been steady, and four years later, in February of 1980, open interest reached a new peak of nearly 58,000 contracts. Annual trading volume, stable at approximately 400,000 contracts from 1971-75, more than doubled during the three following years, and has since more than doubled again in the past three years.

At this stage the Chicago Board of Trade made application, under cover of its letter of October 30, 1980, for designation as a cotton contract market. The contract terms sought in this application were in all major respects those of the N. Y. #2 contract, and the justification was largely in terms of potentially better service to the trade -- better executions, lower transactions costs, better facilities; in short, the promise of a more liquid marketplace with sophisticated and well-capitalized traders. All of this is straight forward and might well provide a welcome test, from a trade and public interest standpoint, of the efficiency of the New York Cotton Exchange. If indeed the CBOT could provide more efficient trading of a virtually identical contract, trade would gravitate to them and New York would have to match the performance or lose the business. If New York could retain or expand its business, and Chicago still build significant volume, this would reflect ever widening use and usefulness of cotton futures. One might only question, in historical perspective, the timing of the CBOT application. The selfsame factors that have frustrated the New York exchanges, notably NYFE and AMEX, the large securities exchanges, in their efforts to break into the financial futures business launched by the Chicago exchanges, these selfsame factors may have frustrated the CBOT entry into cotton futures. These factors all relate to a big headstart -- executions, transactions costs, capacity -- commercial firms and brokerage houses are understandably reluctant to place orders into a fledgling market when an existing and expanding market is much larger and more active. One has to question, also, what portion of the unquestionably sophisticated and well-capitalized membership at the CBOT stood prepared to enter vigorous competition for cotton futures business, what with the several alternative active markets they have to service and several more promising ones pending CFTC approval. Notwithstanding these doubts -- that maybe the CBOT was too late and/or too busy -- the cotton trade and the public could only have welcomed the contest. As the CBOT said in its original application: "The Chicago Board of Trade's introduction into the cotton futures market will either fail or succeed based on the market's evaluation of its ability to perform its functions. Thus, its introduction, even if unsuccessful, would not be contrary to the public's and industry's interest and would simply reflect the normal workings of a competitive system." Fair enough! Unfortunately, the contest was called off, so we'll never know what the outcome would have been.

ENTER CALCOT AND THE CFTC:

Calcot is a large growers' cooperative which handles between 40 and 50 percent of all cotton grown in California and Arizona, making them by far the dominant seller in these markets. They have been vocal critics of the futures market. When I visited executives of Calcot in 1973, seeking on behalf of Cotton Incorporated to learn what improvements might be brought about in futures, they voiced criticisms of the market which they used reluctantly and selectively, but were unwilling to propose any changes. Their strong preference was not to have a futures market. In more recent times, as the market has vigorously resisted its demise, they have focused their attention on obtaining western delivery points on the futures contract. Calcot encountered considerable difficulty in marketing the 1979 cotton crop. In a year of record export sales and strong domestic demand, they held back on sales early in the season, later had to move hedge positions to July from an inverted May market, and paid high interest rates on large quantities of unsold cotton. Having missed the market, Calcot's president lamely explained that they had decided not to sell at the high spot prices because large-volume sales would have driven down the price -- and referred to merchant sales during the high volume months of November, December, and January as "dumping." Consistent with their longstanding posture, they also blamed the futures market; Calcot's president writing to the growers that the market was "squeezed by large speculators and a small number of merchant firms." Calcot appealed to the N. Y. Cotton Exchange and to CFTC to have the delivery period extended, but the appeals were rejected. Commissioner Dunn was quoted as saying, "If we really thought there was manipulation or intended manipulation, we would have done something about it."[3]

Remembering that the initial CBOT application was dated October 30, 1980, the letter from the CFTC Director of Economics and Education to the N. Y. Cotton Exchange, dated November 12, 1980, takes on particular significance as it relates to the CBOT amended application dated February 12, 1981. The CFTC letter required the N. Y. Cotton Exchange to demonstrate its compliance with requirements of contract designation, with special attention to the need for western delivery points and to the adequacy of the penalties against 1 1/32" cotton. Three aspects of this request to the N. Y. Cotton Exchange are of interest. The first is that, from an economic standpoint, the two major concerns tend to be contradictory. If the theory is that western delivery is needed because deliverable supplies are inadequate, this is difficult to reconcile with the concern that a high quality Texas crop enabled the certification of large quantities of Texas cotton in 1978-79. The second interesting aspect of the request is that its two major concerns are easier to reconcile in terms of the Calcot theory. Calcot does not like wide basis swings, and believes that they are caused by the futures market. This theory neglects two facts of life: (1) When good cotton, however defined, is in plentiful supply the basis will widen; and it will narrow or go to an inverse when good cotton is in tight supply. (2) With or without a futures market, price relations among various locations, growths, and qualities will vary over a wide range, reflecting supply and demand. In particular, when Texas has an exceptionally high quality crop, it will compete more strongly with SLM 1 1/16" cotton, and impact more heavily upon Calcot's ability to market cotton successfully. And it must be remembered that Texas cotton is deliverable at a penalty relative to spot market values. No cotton futures contract can be devised which can provide hedgers with a stable basis, nor relieve them of the necessity for assuming basis risks.

---

[3] The Fresno Bee, Fresno, California, June 18, 1980.

The final and most interesting aspect of the request is that the thrust of its two major concerns became embodied in the amended CBOT application dated February 12, 1981. The two significant amendments to the October 30 application are the addition of western deliveries and the deletion of 1 1/32" deliveries. Whether or not this improves the proposed contract, it would seem so responsive to express CFTC concerns as to improve its chances for designation.

THE CBOT RATIONALE FOR THE AMENDMENTS:

The CBOT letter of February 12 goes into some detail regarding the reasoning behind the amendments to its proposed contract. A statistical analysis is performed to show that the level of 1 1/32" certificated stock impacts more on the Fresno basis than on the basis at Memphis or Phoenix. This should not be surprising in light of the fact that both the Mid South and Arizona produced 1 1/32" cotton as California did not. California produces a premium cotton; when that cotton becomes relatively scarce due to larger supplies of a next-best cotton, Fresno prices have to rise relative to other prices, as they did. The CBOT shows that when certificated 1 1/32" stocks rose, Fresno prices rose relative to Memphis prices. They do not show that in 1972 and 1976, when certificated California stocks rose and 1 1/32" certificated stocks were at low levels, Memphis prices rose relative to Fresno prices. This happened as it should have happened. Does this mean that the hedger of Mid South stocks should complain that the basis is too erratic and that deliveries of California cotton should be excluded? Not at all -- it simply means that the market reflected relative availabilities of different cottons. To protect California from other cottons in the futures contract would require limiting deliveries to California cottons on the contract. Even this would not give Calcot what it wants, however -- namely; a steady spot-futures basis, because shortages would still narrow the basis and plentiful supplies still widen it.

On the second major amendment -- the addition of Western deliveries -- the CBOT argues at one point (p. 16) that "to offset the loss of 1 1/32" deliverable supply, delivery points in Arizona and California are to be added" and at another point (pp. 16-17) that the "regulation establishes alternate delivery points with a safety valve feature" in the three Western markets. Given that 1 1/32" deliveries against the New York contract are at a penalty (and a higher penalty is proposed) this may indeed be viewed as a safety valve. But it does not appear that the CBOT proposal introduces a new safety valve. Given that almost 1/3 of California cotton already moves to domestic mills against a 3 or 4 cent freight barrier, the provision of par delivery of SJV cotton in Fresno may look more like Memphis as the safety valve. Table 5 in the CBOT February 12 letter shows that Fresno traded at par or better vis-a-vis Memphis 70% of the time. Taking away 300 points for freight in the same table would create the same effect as Fresno trading at par or better only 32% of the time.[4] Instead of buyers expecting southern delivery, with western deliveries only as a safety valve, it would appear that buyers would be confronted by great uncertainty as to where deliveries might occur. If mill buyers risked deliveries in Fresno, or if export buyers risked deliveries in Memphis, this could be a contract devoid of commercial buying interest.

To the extent that the CBOT proposal reflects CFTC concerns, and to the extent that these in turn reflect Calcot concerns, it may be worth reminding the CFTC of the difference between the commercial hedging of a growers' cooperative such as Calcot and that of a private cotton merchant. Hedging to Calcot is like hedging by an individual farmer -- it is done to establish a price level for cotton they have to sell. The other side of their position, opposite the futures position, is not priced. A private merchant, on the other hand, prices both sides simultaneously -- he buys forward from the grower, for example, at a fixed basis or a fixed price, sells futures against this, and attempts to sell to a mill or for export at a better basis. The difference is important because, having priced both sides, the source of his profits or losses is in basis relationships and basis changes. His business is to anticipate these as best he can. The individual farmer, or Calcot for that matter, is concerned with price level -- wishing to sell at the best price. In selling futures to establish a price, their ideal would be that basis never changes, such that the futures sale establishes the price on the later spot sale precisely. This, of course, cannot occur, because basis variations must and should occur. If basis changes reflect poor futures performance, squeezes and the like, which can be remedied by contract improvement or other measures, users have a legitimate complaint. But very wide basis swings are inherent in the disparate and changing sources of supply and demand for cotton -- these are grist for the mill of the private merchant, while perhaps anathema to Calcot.

---

[4] Actual Fresno and Memphis prices would not be affected, but the CBOT contract would create an approximate 300 point greater incentive to deliveries of California cotton as compared to New York #2 contract.

MULTIPLE DELIVERY POINT PROS AND CONS:

The multiple delivery point issue has been around for a long time. In 1947 the Commodity Exchange Authority (CEA) issueda paper entitled "Need for Multiple Delivery Points in Grain Futures Markets" in which they listed the eleven futures markets then designated as contract markets in grains. The more recent trend at that time had been toward the establishment of markets with various delivery points, at Seattle, Portland, San Francisco, and Los Angeles, each of which provided for delivery at various interior points. Taking its reading from this trend, the CEA argued that the older single delivery point markets at Chicago and Kansas City would need to catch up with the times by providing multiple deliveries. Had they been gifted with foresight, however, they would have known that all of the multiple delivery markets listed were destined to fail while Chicago and Kansas City would continue to thrive with single delivery points. More recently Kansas City launched a multiple delivery market for wheat, approving warehouses at ten interior points plus Kansas City. This contract failed for several reasons, chief among which, according to the president of the exchange, "was having too many approved regular delivery points . . . which was only replacing the cash marketing system. It was a good example of what happens when the market rules . . . get out of balance in favor of one side of the market." This statement was presented at hearings conducted by the advisory committee to the CFTC on the delivery question, at which hearings numerous other persons warned against the notion that delivery at interior cash marketing points could improve futures market performance. There had been considerable agitation from producing areas -- especially Iowa corn producers -- calling for nearby delivery points to protect their basis. This argument failed to take into account, as it always does, that there is a Gresham's Law effect which causes the least desirable deliveries to determine the futures price. The futures price is then no longer representative of the bulk of the commodity flow, and its hedging usefulness is broadly undermined as it becomes in effect a cash market outlet for out-of-position commodity.

The advisory committee adopted the safety valve concept which envisions the establishment of an outside delivery point(s) with deliveries at a penalty to the normal relationship in order to prevent artificial squeezes at the major delivery location. This concept has been adopted for wheat and corn at Chicago, and is the purported concept underlying the CBOT proposed cotton contract, although that is questionable as noted above.

Insofar as true multiple delivery (as distinguished from outside safety valve) is concerned, the present New York #2 contract has probably stretched the concept as far as it can go. The limitation upon multiple deliveries was aptly summarized by W. H. Mills in a memorandum for Mr. Mehl (Administrator of the C.E.A.) in 1949, which said in part: "In point of fact, the disadvantages become one single disadvantage: multiple deliveries will increase materially the uncertainties and risks attendant upon the taking of delivery by consuming buyers." By providing three export oriented and two mill oriented delivery points, the New York #2 contract already confronts buyers with substantial basis risk. The proposal to include western delivery in order to reduce basis risk for one seller (who really does not assume basis risk, as noted earlier) would necessarily increase basis risk to buyers, perhaps to the point of deterrence from buying. There can be little question but that under the CBOT proposed contract, the mill buyer would be deterred by the prospect of western deliveries and the west coast exporter would be deterred by the prospect of Memphis deliveries. These alternatives probably present a wider basis risk than the export-mill alternatives in the New York #2 contract, and may well stretch the multiple delivery concept beyond the breaking point.

MULTIPLE CONTRACTS VS. MULTIPLE DELIVERY ON ONE CONTRACT:

Consideration must also be given to the multiple contract problem as well as the multiple delivery problem, as in certain respects they are alternative solutions to the same problem of diverse flow patterns, grade and quality characteristics, and production areas. In general, the experience with more than one contract for the same commodity on the same exchange has been that only one trades. This is true of cotton at New York: it has also been true of coffee and sugar, and was true of wheat at Chicago and again at Kansas City. It has also been generally the case, with certain interesting exceptions, that contracts in the same commodity complex have not traded successfully on different exchanges. Kansas City and Minneapolis have failed to establish corn and soybean contracts in competition with Chicago, the CBOT has failed in efforts to establish livestock contracts in competition with the Mercantile Exchange, and thus far the New York exchanges have failed to establish financial instrument contracts in competition with Chicago. The dominant reason for the concentration upon one contract at one exchange has undoubtedly been liquidity.

The exceptions to the one-contract one-exchange rule are in some respects more instructive than the rule. The exceptions have been of two kinds. One is where an exchange launches a virtually identical contract, and by virtue of its greater capacity in terms of a well capitalized, aggressive, and sophisticated floor trade contingent, can create an active market even where one already existed. This happened in silver futures, when the CBOT established another active market although one already existed in New York. This was also the essence of the initial CBOT proposal in cotton.

The other kind of exception has been found in instances where the markets served quite distinct needs -- geographically, commercially, or functionally. Thus, for example, Liverpool traded grains and cotton, and Winnipeg traded grains by catering to needs not adequately served by the dominant Chicago market. New Orleans traded cotton by catering to speculative interests while New York served hedging needs better. The satellite markets have always relied to a considerable extent upon the price discovery at the major market, spreading into that market to reflect local differences. An extreme example is the Mid-America Exchange in Chicago, which caters to small, "odd lot," trades and links all of these into the CBOT through a "changing" system with CBOT members.

The most relevant example of the success of satellite markets in the present context occurs in wheat futures. There three markets have survived in the United States; Kansas City as a robust satellite and Minneapolis a less healthy satellite of the CBOT wheat futures market. The relationship between Chicago and the satellites, and the factors which determine the survival of the satellites, has been examined in earlier publications.[5] Essentially, the three markets trade different classes of wheat: Minneapolis trades Spring Wheat; Kansas City trades Hard Winters; and Chicago, while allowing deliveries of all three classes, is essentially a Soft Winter Wheat market. Both Minneapolis and Kansas City rely heavily upon spreading to Chicago to provide adequate liquidity. Commercial interests are enabled to hedge substantial quantities of hard wheats in Kansas City by relying upon the spread to Chicago.

---

[5] See Holbrook Working, "Whose Markets? Evidence on Some Aspects of Futures Trading," Jour. of Marketing, July, 1954; Roger Gray, "The Relationship Among Three Wheat Futures Markets," Food Research Institute Studies, Feb. 1961; and "Price Effects of a Lack of Speculation," F.R.I. Studies, Supp. to Vol. VII, 1967.

The reason that the wheat futures complex is relevant is that a somewhat similar situation prevails in cotton. One would have thought that if another exchange decided to trade cotton futures, they might have developed a short staple contract to attract Texas and/or a Western Delivery Contract, unless, of course, they were to compete head-to-head for the New York #2 contract. Perhaps the experience with the New York #1 contract was a deterrent, but if CBOT believes that New York lacked capacity to adequately service its #2 contract, surely they must believe that they can't service two contracts, so a contract similar to #1 should have held some appeal. So far as a Western Delivery Contract is concerned, if the CBOT finds no reason to fear the dominance of Calcot in that market, again one would have thought they might attempt a Western Delivery Contract. As indicated earlier, there is a distinct possibility that instead of the current proposal being a New York #2 contract with a western delivery safety valve, the proposed differentials simply create too much buyer uncertainty as to which area the futures would reflect. This would suggest that western delivery be protected by a distinct penalty against southern delivery, to find out whether there is sufficient buyer interest to support a Western Delivery Contract.

WEST COAST DELIVERIES:

Any attempt to include western delivery at near parity with eastern delivery appears doomed to failure because of excessive risk to the buyer. The Minneapolis Grain Exchange tried Portland and Seattle delivery points on its contract which failed for this reason. As Alvin Donahoo of the Exchange testified at the Kansas City hearings in 1976, "if the holder of the warehouse receipt got delivery in Portland, but needed it in Minneapolis, the cost of the return movement would have been prohibitive. The contract would have lost all value as a hedging tool for the commercial interests in the Midwest, the East or the South."

It should also be noted that West Coast ports serve different destinations from Gulf ports, or the same destinations at quite different freight costs. It has been argued that the CBOT proposal would be ttractive to export buyers, because cotton can be delivered from any delivery point to the nearest port for about 1 cent per pound. This neglects the consideration of destinations. A problem with the Minneapolis wheat contract, which has permitted delivery at Minneapolis or Duluth-Superior is relevant. Inbound freight to Minneapolis or Duluth-Superior is the same, so that is no problem. But the destinations, particularly via water, are much different, so it matters significantly to the buyer at times where the wheat is received.

CASH MARKETS VS. FUTURES MARKETS:

Futures markets best fulfill their major purposes of discovering a representative price level for a representative grade and quantity of a commodity when they do not attract substantial deliveries. The marketing of the cash commodity is normally more advantageous to buyer and seller off the futures market. Futures markets which attract substantial deliveries are indications that something is out of kilter -- and those which have persistently attracted substantial deliveries have, without exception, failed. When certain selling or buying interests find that the futures market is a convenient alternative source of disposal or procurement, this can only mean that the futures market is favoring them over the more general interest. For a period of years the soybean meal contract at Chicago contained freight provisions that favored the easternmost processor. In consequence, this processor repeatedly tendered deliveries, which he could afford to make but buyers couldn't afford to take. The freight provisions had to be altered because this use of futures as a cash outlet was a deterrent to other users, distorted prices, and discouraged widespread participation.

When producers or other sellers look upon the futures market as a cash outlet, they are misconstruing its role. When they are enabled to use it as a cash market outlet, it is unevitably not performing its role for others.

In the 1979-80 crop year, Calcot essentially missed a strong market while others were selling into it. This left them with a local surplus of cotton while cotton was elsewhere in short supply. When May futures went to a premium over July, this reflected a market shortage in the face of Calcot's out-of-position surplus. Calcot's allegation of price manipulation was not supported by Exchange or CFTC findings. Calcot implies by its argument that it should be permitted to manipulate its way out of this situation by delivering cash commodity into futures at its own doorstep.

THE ROLE OF THE SHORT SELLER IN FUTURES MARKETS:

Most of the concern over futures market abuse -- squeeze, manipulation, or corner -- focuses upon the role of the long. It may well be that most manipulation or attempted manipulation has historically come from that side. In any event, CFTC concern with delivery points as they relate to price manipulation has clearly emphasized the liberalization of delivery terms to forfend against long side manipulations. To balance the picture, it must first be recalled that futures contracts are sellers' option contracts -- the seller chooses which of the various deliverable grades to deliver and where to deliver them. This too presents potential for manipulation; and the potential grows as the terms, conditions, and locations are liberalized and expanded. It is also true that the short who overstays a market creates congestion, and indeed may create the appearance of a long-side manipulation. The short has an obligation to cover or to prepare to make delivery. If he does neither he is likely to delay a necessary upward price adjustment which may then appear to some as though longs manipulated. Shorts may also, by adroit management of the stocks they have to sell, influence prices to their advantage. Moving stocks into or out of deliverable position may accomplish this; whereas in the case of cotton, certification or decertification of stocks may have price effects which the seller desires. In consequence of these various possibilities, buyers become disaffected. The concession to the persistent importunings of a major short which is embodied in the CBOT cotton proposal may indeed leave it devoid of buyers.

THE POTENTIAL FOR MANIPULATION OF THE PROPOSED CBOT COTTON CONTRACT:

Contrary to the more common concern with long-side manipulation, the proposed contract appears to be more susceptible to manipulation from the short side. This relates partly to the extreme concentration of California/Arizona Cotton Sales in the hands of Calcot. It relates further to the fact that Calcot takes into storage an enormous quantity of cotton (about 2 million bales) at harvest time, and is able to finance these stocks throughout the marketing season more cheaply than a private merchant can. The temptation to certify or decertify these stocks as the futures price appears to Calcot to be out of line could be very great. Calcot's preoccupation with what it considers to have been unwarranted basis movements suggests that they would not be reluctant to exercise the power embodied in huge stock accumulations for purposes of "correcting" the basis.

SOME FINAL QUESTIONS:

Will the proposed CBOT contract attract significant trading volume and open interest? Nobody knows for sure. My own respect for the institution of futures trading and for the Chicago Board of Trade inclines me not only to wish them every success in this venture, but to predict success based upon their past record. Nevertheless I remain highly skeptical on the various grounds stated in this report, and also on the basis of the member survey conducted by the American Cotton Shippers, which does not augur well for trade participation.

If the proposed contract trades, will it trade primarily as a western delivery contract with an export orientation? It is of course not presented as such, being presented as a contract with a western delivery safety valve. I am skeptical also on this score.

If it trades, will it improve the performance of the New York #2 contract? Not particularly if it trades as a western contract, and not in any event as much as the original CBOT proposal might have done.

Will it benefit California Producers (if it attracts trading)? Any well-functioning futures market benefits producers. I think, however, that the Calcot members who were supposed to have been harmed by lack of Calcot's ability to deliver locally, which this is supposed to remedy, will not derive that particular benefit. Even if Calcot were to exert considerable influence on the basis in this contract, that would not raise cash returns to its members. Neither Calcot nor its members profit or lose in a direct financial sense from basis changes, as does a private merchant. Calcot members benefit according to how successfully their cotton is marketed in competition with other cottons, and, of course, according to the general demand for cotton.

SUMMARY AND RECOMMENDATIONS:

This report has attempted to provide some historical and analytical basis for assessment of the proposed CBOT cotton contract. The contract originally proposed would have challenged the New York #2 contract in head to head competition, and if enthusiastically supported by CBOT members would put the New York market to a stern test. The two major amendments to the contract originally proposed -- one deleting 1 1/32" deliveries and the other adding western deliveries -- clearly reflect CFTC concerns expressed in their 1.50 letter to the New York

Cotton Exchange, which in turn clearly reflect the Calcot position. To whatever extent this indicates politicization of contract writing it could be an unfortunate precedent. The CBOT rationale for the two major amendments is not very persuasive, and continue to reflect the contradictory concerns in the 1.50 letter regarding delivery capabilities -- too little where California/Arizona is concerned; too much, where Texas is concerned. It seems to me likely that western deliveries have been included at near parity, rather than as a safety valve as announced, and that the consequence may be too much uncertainty for buyers as to which location is reflected in prices. The Fresno-Memphis spot price differential has traded over a 1200 point range in the past decade, and even without considering 1 1/32" deliveries, traded over a 900 point range in successive years when 1 1/32" certificated stocks were inconsequential. This, in my judgment, may stretch the risk to the buyer in one futures contract beyond the breaking point.

My recommendation would be that the original CBOT proposal be reconsidered.

ROGER W. GRAY
STANFORD UNIVERSITY
August 25, 1981

STATEMENT OF DANIEL G. AMSTUTZ, CHAIRMAN, COMMODITY EXCHANGE COMMITTEE, NATIONAL GRAIN AND FEED ASSOCIATION

Mr. Chairman and Members of the Subcommittee:

My name is Daniel G. Amstutz. I am a general partner of Goldman, Sachs & Co., New York, New York. I am Chairman of the Commodity Exchange Committee of the National Grain and Feed Association on whose behalf I appear today.

The National Grain and Feed Association is a voluntary association of grain and feed firms, independents and cooperatives, ranging in size from the smallest country elevator to the largest grain and feed complex. Included in its membership are country and terminal elevators, merchandisers, processors and exporters covering the wide spectrum of the grain and feed industry. Our membership is comprised of 1,250 companies and 46 state and regional grain and feed associations affiliated with the National which include upwards of 10,000 grain and feed companies nationwide.

Our members rely heavily upon futures markets to hedge their purchases and sales of agricultural commodities and dealings in other commodities and instruments thereby reducing their business risks to the benefit of producers (farmers) and consumers. The continuous price discovery mechanism of futures markets permits our members to offer a fair price to producers and consumers alike.

We believe, as we have believed since the creation of the CFTC, that all futures markets should be regulated by an independent regulatory body. Thus we recommend that no substantive change be made in the Commodity Exchange Act as it relates to the jurisdiction of the CFTC pertaining to futures markets. We basically agree with the reported agreement between the CFTC and the SEC regarding the division of regulatory authority over options markets whereby the CFTC would have exclusive jurisdiction over all permissable futures contracts as well as options on those futures contracts, and would regulate options directly on foreign currencies traded on commodity markets. We would, however, disagree with any veto power being granted to the SEC or any other Federal Agency in any area where the CFTC has exclusive jurisdiction.

We are concerned about proposals that call for margin authority to be vested in one or more government agencies. It is our firm belief and strong recommendation that no legislative change be made regarding margins on futures contracts. We believe margins on futures' contracts should continue to come under the purview of the individual futures markets.

There seems to be continuing confusion about futures market margins that cause some to believe that there is a great similarity between margins on securities and margins on futures contracts. The purpose of margins in securities markets is clearly stated in the Securities and Exchange Act of 1934 whereby margin refers tc the required level of down payment on credit purchases of securities. In other words, the purchase of securities on margin is a credit transaction, entailing transfer of the right to use and enjoy capital assets, e.g., common stocks, and also entailing the lending of funds.

In contrast, the purchase and sale of a futures contract on margin is not a credit transaction. The only capital asset involved is the commodity itself which can only be used after delivery occurs at which time ownership is financed through otherwise established credit facilities not under the control of commodity exchanges, chiefly the banking system. Since no title is conveyed prior to delivery and no loan is extended, no credit is involved in a futures transaction, hence the word "margin" has an entirely different meaning in this context, and the purpose of margins is different.

The purpose of margins in futures markets is to insure the financial integrity of all futures contracts trading on these exchanges. The purpose of margins in securities markets is to serve as a down payment. The function of securities markets is to transfer title, from one owner of a security to another. The function of futures markets is not to transfer title, rather it is to transfer price risk. Recognition of the difference in function between these institutions should help in understanding the differences between them regarding margin concepts.

We do not believe any government agency, no matter how enlightened or well-intentioned, possesses the capability to manage the margin responsibilities for futures markets. We do not believe any government agency could be sufficiently responsive to changes in margin levels that frequently must be effected in an environment of fast breaking changes that necessitate rapid, immediately implemented, decisions. In our judgment, only the individual exchanges have the capability to deal with the logistical realities of margin setting responsibilities regardless of the underlying commodity. It makes no difference whether the commodity is a traditional one, e.g., wheat, or a "new" one such as a price index on equity securities.

In the current climate of required fiscal restraint on the part of the Federal government we recognize government's desire to explore the concept of user fees as a source of revenues. We have several comments to make in this regard.

We do not believe that any Federal Agency should be granted authority to directly tax those who are regulated by that agency. Obviously any authority for self-sustaining revenues generated by self-ordained taxes imposed by any agency would, we think, create inequities and inefficiencies that could be mortally damaging to the so-called users subject to such direct taxation.

We are thus firmly convinced that any system of user fees adopted by the Congress should contain the proviso that all revenues resulting therefrom flow to the U.S. Treasury and that any and all agencies that are directly or indirectly financed from these revenues continue to follow the procedure of requesting appropriations from the Congress as a means of annual budgetary control and oversight.

We think it is an uncontested fact that the price discovery process of futures markets provides significant value to all segments of the Nation's economy. The Congress should recognize this when determining what portion of the CFTC's operating expenses should be borne by general Treasury revenues and what portion should be covered by specific, narrowly focused user fees. In our judgment it would be inequitable and an injustice if the Congress would determine that anywhere near all the revenues necessary to cover the CFTC expenses should come from user fees.

It is our understanding that a very substantial portion of the CFTC's expenditures are devoted to: (a) the process of examining and approving new contract proposals, (b) investigating and/or overseeing activities of commodity pool operators and commodity trading advisors, and (c) matters pertaining to those futures commission merchants who are not members of contract markets. Implementation of a realistic fee structure to cover those high cost areas for the CFTC, assessed as fees for new contract approvals and registration and auditing fees for CPOs, CTAs, and FCMs would, we think, provide the means for collecting needed revenues. We believe that any cost/benefits analysis would endorse our view that a user fee structure that focuses on those categories of users or uses of CFTC services, those which create the operating expenses for the CFTC, is the most equitable manner in which to levy such taxes.

We are opposed to a user fee approach based on across-the-board transaction fees. We consider such a concept to be inequitable. The preponderance of such transaction fee taxes would be levied on those who provide market liquidity, commercial hedgers and independent traders, yet these are not the entities that create the expense load for the CFTC. Constraints resulting from transaction fee taxes could restrain the trading activity of those who are, in a very real sense, the market makers. Transaction fee taxes would thus adversely affect all-important market liquidity.

The National Futures Association was designated as a "registered futures association" on September 22, 1981 by the CFTC with Congressional endorsement. It was formed to assume some of the regulatory burden now borne by the CFTC. Any user fee approach adopted by the Congress should recognize that the CFTC's need for revenues should diminish as the NFA becomes operational. A substantial portion of the NFA revenues will be collected via user fees. The Congress should be wary of the possibility of dual user fees for duplicative regulatory functions being assessed on market users. In order to guard against this and to help insure that an equitable user fee concept is adopted, our Association recommends that an Advisory Committee be authorized to make recommendations to the CFTC on this important issue. We believe all segments of the futures and futures using industries should be represented on this committee.

From time to time it appears that some conclude that the regulation of cash commodity forward-contracting should be undertaken by the Federal government. The National Grain and Feed Association strongly recommends that no added provisions for the regulation of cash commodity forward-contracting be included in the extension of this legislation.

This Association, in previous testimony, has stated that it is not opposed to the initiation of Commodity Options trading under the regulation of the CFTC. At the present time it is not lawful for options trading to be conducted in the U.S. on those agricultural commodities that are traded on U.S. futures markets which were regulated by the predecessor of the CFTC (the Commodity Exchange Authority). We welcome the initiation of the CFTC regulated pilot program on options. Concurrent with the functioning of the pilot program the National Grain and Feed Association will be studying the feasibility of options trading on grains and oilseeds. Subject to the success of the pilot program on permissable commodities and subject to positive findings of our task force that will be studying the subject, we may eventually recommend that legislation be enacted to permit trading in options on grains, oilseeds, and oilseed products. At this particular time, however, we believe it would not be appropriate to introduce such legislation.

We recommend that the Commodity Exchange Act, as amended, be extended for a period of four years.

The National Grain and Feed Association desires to be helpful to the Congress as it considers this reauthorization legislation.

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION TO THE SUBCOMMITTEE ON AGRICULTURAL RESEARCH AND GENERAL LEGISLATION OF THE SENATE COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY REGARDING PROPOSALS TO EXTEND AND REVISE REGULATING AUTHORITY FOR THE COMMODITY FUTURES TRADING COMMISSION

Presented by
Stuart E. Proctor, Jr., Assistant Director,
National Affairs Division

March 2, 1982

We appreciate the opportunity to present Farm Bureau's comments on proposals to revise and extend the regulatory authority of the Commodity Futures Trading Commission (CFTC).

Farm Bureau is the largest general farm organization in the United States with a membership of over 3.1 million families in 48 states and Puerto Rico. It is a voluntary, nongovernmental organization, representing farmers who produce virtually every commodity produced on a commercial basis in this country.

Futures markets provide a continuous market for the commodities that are traded and enable both farmers and the handlers to whom farmers sell their products to transfer, or reduce, the risks of unfavorable price movements. Futures markets also serve farmers as a source of price information. Only a small percentage of agricultural producers use the futures market to directly hedge their positions, but all producers benefit from the services provided to the marketing system.

At the 63rd annual meeting of the American Farm Bureau Federation in January, 1982, the voting delegates of the member State Farm Bureaus adopted the following policy on commodity futures trading:

> "Commodity futures trading serves a useful purpose for a number of commodities by providing a means to transfer certain types of risk. Other commodities, such as cotton seed, should be included where need exists and research shows futures trading would be beneficial. We urge that regulatory laws be strictly enforced.
>
> "We will:
>
> (1) Aggressively seek additional agricultural representation on the Commodity Futures Trading Commission (CFTC) and other regulatory commissions affecting agriculture;
>
> (2) Oppose efforts by the CFTC to regulate cash grain;
>
> (3) Request oversight hearings by the appropriate committees of Congress to see if the interests of agricultural producers are being harmed by actions of the CFTC in regulating grain markets; and

(4) Oppose efforts to combine the CFTC and the Securities Exchange Commission (SEC).

"We recommend that efforts to establish delivery points for live hog and cattle futures in the Southeast and West be continued. We recommend that efforts be made to establish delivery points for eastern soft white wheat."

We recommend approval of legislation to extend the Commodity Futures Trading Commission Act.

Farm Bureau has supported the basic concept of a user fee system for the Federal Grain Inspection Service as part of President Reagan's Economic Recovery Plan. We agree with the philosophy that those who directly benefit from government service should be required to pay the regulatory cost.

We will support a user fee schedule for the CFTC in which there is a more direct relationship between the fee and the benefit, i.e., a fee on contract registration, company and individual registration, and audits. We will also support a user fee on each transaction if it is designed to recover the regulatory cost of that transaction only, and if a cap is placed on the total amount of collections. However, we are hesitant to support the CFTC user fee proposal because users may be paying for a disproportionate share of the regulatory cost. There is no recognition of the benefits of regulation which accrue to everyone in the marketing chain, including consumers. Farm Bureau is also reluctant to support the CFTC proposal without an analysis of its impact on speculative trading and on market liquidity.

Trading in agricultural options may be an important marketing tool for farmers, particularly during periods of market volatility. The Board of Directors of the American Farm Bureau Federation will meet in Washington, D.C., in March and consider a proposal recommending that CFTC be authorized to include agricultural commodities in its options trading pilot program. We would like to supplement our statement after the Board takes action on this subject.

Farm Bureau has supported the regulatory reform provision in the President's Economic Recovery Plan. Granting CFTC the authority to directly regulate speculative limits would require additional government involvement and run contrary to this plan. We favor continuing the current system which allows each exchange to regulate speculative limits and grants CFTC oversight responsibility.

In 1981, the agricultural community actively worked to ensure that one of the two vacancies for Commissioner be filled by a qualified individual who was knowledgeable in agricultural affairs. Farm Bureau applauds the appointment of such a person.

Although the volume of agricultural contracts has been declining as a percent of total trade, it still represents about 50 percent of all futures contracts. Of the ten most active contracts, six were agricultural. Of all commodity groups traded, agriculture ranks first and is more than twice as large as financial instruments, the second most actively traded group. We recommend that the Committee Report recognize the importance of agricultural trade and indicate a desire to have at least one of the five Commissioner positions filled with an agricultural representative.

We thank the Subcommittee for this opportunity to present Farm Bureau's views on this important topic.

STATEMENT OF JACK A. BARBANEL, GENERAL COUNSEL, COMMODITIES CORPORATION, PRINCETON, N.J.

MR. CHAIRMAN, MEMBERS OF THE SUBCOMMITEE, LADIES AND GENTLEMEN:

BEFORE I BEGIN, PERMIT ME TO EXPRESS MY GRATITUDE FOR THE OPPORTUNITY TO TESTIFY BEFORE THIS SUBCOMMITEE AT SUCH A CRUCIAL PERIOD FOR THE CFTC AND THE FUTURES INDUSTRY.

My name is Jack Barbanel. I am a Vice President and General Counsel of Commodities Corporation, a privately held company that trades futures, forwards, physicals, and to a lesser extent securities for its own account, serves as a consultant to other users of the futures markets, and through its wholly-owned subsidiary manages, as trading advisor, approximately $40 million of publicly offered commodity pools' funds. The Company is a registered commodity pool operator, trading advisor, and is also a member of major commodity exchanges.

I think I should also mention something about my own background. Prior to joining Commodities Corporation, I served as Associate General Counsel and later as Vice President, Counsel and Director of Commodities Operations at Smith Barney, Harris Upham & Company, a highly regarded investment banking firm and futures commission merchant. Before becoming associated with Smith Barney, I was a trial attorney with the United States Securities and Exchange Commission, Division of Enforcement, in the New York Regional Office.

I am appearing today in my corporate as well as personal capacity.

I will address three areas of concern in connection with the impending reauthorization of the CFTC: (1) speculative limits; (2) user fees; and (3) state jurisdiction as it affects commodity pools.

SPECULATIVE LIMITS

Mr. Chairman, the CFTC in its proposal to establish speculative limits on all traded contracts has a stated objective to prevent "excessive speculation" which in turn may cause unreasonable flucuations or unwarranted changes in supply and prices of a particular commodity. Otherwise stated, the CFTC is attempting to prevent prices which are not reflected in the real world of supply and demand. I believe that the speculative limit rule recently proposed and promulgated, is nothing more than a knee jerk reaction to the recent, so-called, "manipulation" and "squeeze" of the silver market. The rule, by its own terms, appears to imply that the CFTC is incapable of properly monitoring and rationally regulating the marketplace and, therefore, it should impose such constraints that in effect would relieve the agency from its monitoring responsibility. An analogous example can be made to the current gun control debate, that is, let's take away all the guns and no one would commit crimes. However, we all know that people commit crimes, not guns. This logic can be equally applied to the issue at hand. No limits, or rational limits, do not in and of themselves cause "squeezes" or "manipulative prices;" it is the individual behind them. We must recognize that the size of a position or the affecting impact per se do not legitimize the position, but rather the motivational forces behind the accumulation of the position or the sought-after effect. Intent to manipulate, and to so act as to accomplish the manipulative goal is what should be scrutinized. Why then punish the ethical and well-intended market participants, which comprise the vast majority of the market users, for the misdeeds of the unscrupulous. Is it not enough for the CFTC and the Exchange to monitor large trader reports which clearly disclose the positions owned by a particular account? As an example, let us take a look at the equity market. As an investor, I am not restricted from accumulating a substantial position in IBM shares provided that I have complied with certain SEC filing requirements when reaching a designated percentage of the total flow. However, I am not absolutely restricted to a limited amount of shares that I can purchase. The SEC monitors substantial purchases and sales of securities as the CFTC could just as easily monitor futures transactions. The SEC and the stock exchanges have been able to closely monitor and investigate, to their satisfaction, price fluctuations and transactions which appear suspicious in nature. I think the equity markets can provide a good example to follow in establishing a rational framework for the futures markets.

Further, speculative limits alone will not prevent "squeezes" and manipulations, since the unscrupulous mind undoubtedly will find a way to make or innovate a scheme to circumvent speculative limit requirements.

Although, the CFTC may have good intentions in establishing speculative limits, the price may be too high in comparison to accomplishing the same goals with less industry restraint and more responsibility being placed on the Exchanges to monitor price fluctuations, deliveries and large accumulations of positions. Irrational limit constraints may force the domestic user to utilize off-shore exchanges, which do not impose limits, with the resulting effect being a loss of the transaction, in substantial dollar amounts, to U.S. banks, brokerage community and Treasury. Foreign markets will have an opportunity to grow at the expense of the over-regulated U.S. markets.

In 1975 the CFTC established an Advisory Committee on the Economic Role of Contract Markets. In July of 1976 the Committee issued a report of their findings, concluding that the then existing limits were unable to adequately address price manipulation and congestion in the delivery months. The Committee further concluded that limits do not (and I quote), "effectively limit the abusive market power of the large commercial firms" (end of quote) that enjoy bona fide hedge exemptions from limits (as is presently proposed); and that the limits are not effectively tailored to delivery month conditions, when the potential for manipulation is the greatest. The Advisory Committee further noted that limits are (and I quote), "not a very powerful [regulatory] tool ... nor can they be made to be so" (end of quote). Accordingly, the Committee recommended that position limits (and I quote) "be supplanted by an improved monitoring and a surveillance program designed to achieve orderly liquidation of expiring contract months" (end of quote). The same Advisory Committee also recommended that the CFTC's existing limits not be imposed on new contracts, or on contracts without a limit, on the ground that; (and I quote),

> "speculative position limits would have almost no utility at all for many of the newly-regulated commodities. Those with a dependably broad supply (no seasonal factors, no storage problems, easy transportability) and those which may be arbitraged from highly liquid markets in other countries would derive even less benefit than speculative positon limits usually provide. In those commodities which are also traded on liquid futures markets overseas, such limits would be ineffective at best and at worst could drive trading away from the U.S. Exchanges." (end of quote).

From an economic perspective, the price discovery function in the futures markets largely depends on the existence of the speculator. It is highly unlikely that even the unscrupulous speculator would be able to put a "squeeze" on a contract in the nondelivery months, due to the enormous amount of money and financing entailed in creating a "squeeze" months before the delivery month. Thus, I believe, a funnel approach could be a useful way of addressing the issue. That is, the limits starting out on a particular contract would be economically flexible (high) and as the contract nears the delivery period the limits would narrow.

I believe, the CFTC's previously noted study clearly shows that the silver situation is being exploited in the abstract. Different commodities have different underlying characteristics and deliverable supply. Assuming that someone, or some entity, was intending to "squeeze" a particular contract, and assuming that the individual or the entity had the financial resources, certain contracts would be more susceptible to a "squeeze" than others. For example, to "squeeze" the cotton market would be much easier than the Swiss Franc. There is a lesser supply of deliverable grade cotton than the Swiss Franc. Thus, it may make sense that a rational funnel approach be taken in the cotton contract, with high or no limits imposed on the Swiss Franc. Each contract should be examined independent of any predetermined irrational bias.

Included in the package of proposed legislative changes submitted to this Committee by industry represenatives, including the National Futures Association, is a proposal to amend §4a(1) of the Commodity Exchange Act to modernize its language and its philosophy. The present language in §4a(1) suggests an unnecessary and inappropriate bias against speculative trading in the commodity futures markets. The industry and the CFTC recognize that because of the substantial increases in market volume since the Commodity Exchange Act was adopted in 1936, there is a need for corresponding increases in speculative trading in the futures markets. At the same time, the industry and CFTC both recognize that market users, whether speculative traders or hedgers, should not be allowed to engage in the manipulation, "cornering", or "squeezing" of the futures or the new commodity options markets.

The language suggested in the industry proposal may accomplish these dual purposes. The proposed language makes clear that the CFTC may impose speculative limits but that those limits must not be an end in themselves; they must have as their purpose the prevention of manipulation, "corners" and "squeezes". In this connection, the industry proposal would require the CFTC to take certain factors, including volume, open interest, and arbitrage opportunities, into account in determining the size of any speculative limits imposed on the market.

While as a compromise I support the industry proposal, I recommend, as my earlier comments suggest, that we go further. While we recognize that speculative limits may be a helpful regulatory tool in some markets, I do not believe they are necessary in any market and can in fact be harmful (again I draw your attention to the CFTC Advisory Committee Report). I recommend that the Congress direct the CFTC, either by legislation or, in the alternative, by language in Committee reports to reassess its rule requiring Exchanges to adopt limits in all commodities, and to take steps to encourage the increasing of open interest in distant delivery months in those commodities where limits are imposed. It is the more distant months which are important to hedgers -- the primary beneficiaries of these markets -- and it is the more distant delivery months that are most immune to manipulation, "cornering" or "squeezing". The funnel approach suggested earlier in my testimony, would provide encouragement for speculators to take positions in the more distant months, thereby providing liquidity in those months which are most beneficial to hedging activities. This approach would allow for increased usage of the markets, while not increasing any susceptibility of a market to manipulation, "cornering" or "squeezing".

One could argue that, with all the suggested monitoring, compliance with form-filing and potential for investigations, it just would not be cost effective; additional staff would be required, computers programmed, and judicial/administrative enforcement of antimanipulative rules will be instituted. Well, is not what I have just described the job of a regulator -- to regulate, not play economist in the absolute sense? Is this not one of the key reasons why the CFTC is seeking to establish user fees, to support its regulatory program?

However these programs are financed, either through direct taxes or, potentially, user fees, the program should not be one of regulatory welfare, but a rational approach towards protecting the public interest, without sacrificing the business the CFTC was authorized to regulate.

USER FEES

Now let us address the user fee issue. Although the amount of the CFTC's proposed user fee appears to be insignificant, it is substantially higher than the fees being levied in the equity markets. Let us not forget that the CFTC user fee, if adopted, would be levied in addition to fees that will be paid to the NFA, the Exchanges, clearing corporations, floor brokers, and executing agents -- it is significantly more expensive to execute a futures contract than it is to purchase or sell a security.

If we, as users, are to be taxed to support the CFTC's regulatory program, what are we receiving in return? The answer appears to be: more costly regulations and inflexibility. Why, I ask, should the ethical user of the marketplace pay for the regulations created by misdeeds of the criminal mind? Does it not make more sense for the CFTC to impose substantial penalties on a criminal and violator of the Commodities Act and the rules which are promulgated thereunder?

"Crime does not pay," should be the underlying motto for establishing severe penalties against violators. There is no reason to punish the ethical user with a tax that is proposed to be used not necessarily to the direct benefit of the user that is being taxed. Be that as it may, if these fees are being justified on the grounds that the CFTC will use such funds to protect the public interest, and the Exchanges, the NFA, and the states assert similar grounds in justifying fees, then I think, we are being expensively overprotected without yet seeing a valid benefit.

The industry, I believe is very concerned about, crime, violators, bucket shops, and schemes which infilterate their business and create an appearance of an unruly, uneducated and unprotected marketplace. This appearance and image problem is of great concern to all ethical participants of the futures industry. Its reputation is at stake, at a time when the industry is steadily growing, and at a time when more sophisticated institutions plan to enter its active arena. Business for the industry can only grow if it can show to the potential user an economic benefit with reasonable safety. We all recognize this, and will attempt to rationally achieve this goal. To regulate is to rectify and improve, not restrain and constrict. Self-regulation, with CFTC and Congressional oversight is, I believe, the rational approach to take.

CFTC/SEC JURISDICTIONAL ACCORD

Now permit me to focus in on the subject of the CFTC/SEC jurisdictional accord, and legislative proposals. As a manager of significantly large publicly pooled funds, we are in basic agreement with the CFTC/SEC compromise and strongly support the proposed legislative changes by the two agencies. The CFTC, SEC and their respective chairmen must be commended for resolving this important and confusing issue, which in the past plauged the formation and marketing of publicly offered participations in pooled commodity funds.

In addition to the CFTC/SEC proposal, I would recommend that any rules and regulations to be promulgated under the adopted proposal be uniform and concurrent, so as not to create a potential for conflict in the manner and substance in which one is to comply.

The proposed CFTC/SEC legislation must also be absolutely clear, that in the area of commodity pools, only the CFTC and SEC will have clearly defined jurisdiction, and that the states' security "BLUE SKY" regulations will be specifically pre-empted in all respects. Presently, I believe, the states have neither the qualified personnel, nor the manpower to equitably deal with the commodity pool product. There is a considerable lack of understanding on the part of the states, of the futures markets and related investment products. Should the states be permitted to exercise any jurisdiction over commodity pools, I am afraid that the reaction may well be one of foreclosing the pool product in a particular state.

Presently, there are at least two states that in effect preclude the offering of public commodity funds to their residents, and a few other states impose irrational and overbearing constraints, which in effect accomplish similar results. The attitude by certain states appears to be "if we don't understand it, then let's restrict it."

We believe, that the CFTC, the SEC and the NFA will be well equipped to protect the public interest in this area. Uniform regulations by the two agencies will also be cost-effective, in that, the pool will be subject to a well-defined national regulatory structure, instead of the potential of complying with 50 different guidelines, rules and regulations, which in the long run, may prove to be an expense not only to the promoter of the pool, but also to the prospective investor. This cost will undoubtedly be passed on to the investor.

In any case, under the present proposals before Congress, the investor shall have a private right of action coupled with the state and federal criminal jurisdiction, and CFTC/SEC enforcement measures to be adequately protected from potential abuses in this area.

CONCLUSION

In conclusion, I wish to state for the record that the CFTC and its staff are being unjustly persecuted by the media and certain interest groups. In the past few years, and in particularly recently, under the leadership of its Chairman, Philip Johnson, the Commission has taken great strides in educating the public and making the futures markets safer than they were ever before. I have no doubt that the quality and understanding of this industry will continue to improve.

Thomas Jefferson in a letter to John Adams once wrote, and I quote, "I like the dreams of the future better than the history of the past" (end of quote). This should be the motto under which the industry and its regulators should work together and, ultimately, be judged, and if we all do a good job, then at the next Reauthorization Hearings I will be able to comfortably say 'that I like the dreams of the future because we had a proud past.' Thank you.

STATEMENT OF AMERICAN AGRICULTURE MOVEMENT TO HOUSE AGRICULTURE SUBCOMMITTEE ON CONSERVATION AND CREDIT

Presented on February 24, 1982 by Don Eret

Mr. Chairman and members of the Subcommittee on Conservation and Credit. I am Don Eret, farmer from Dorchester, Nebraska. I am here to make a statement for the American Agriculture Movement to establish for the record that the Commodity Futures Trading Commission (CFTC) is clearly not carrying out its responsibility in administering the Commodity Exchange Act.

A major provision of the Act is to limit or abolish speculative short selling of commodity futures contracts when such selling creates a burden on interstate commerce. It is a fact that commodity prices are so low that shipments of grain and other commodities have decreased to such an extent that thousands of railroad employees along with employees in commodity related industries have been layed off from their jobs. Whether the low prices would have ultimately developed in the course of cash market trading between the producers and the processors and exporters without the price depressing speculative short selling of futures is a debatable subject of the economy. It is for sure that prices cannot recover thru orderly marketing by producers to match demand with supply as long as the current practice of speculative short selling prevails.

Nevertheless the resulting burden on interstate commerce of farm commodities due to low prices has become so extensive that it is an unmistakable fact that the CFTC has defaulted in its responsibility to effectively limit or to abolish speculative short selling of the commodities as required by the Act of Congress. The CFTC has in fact moved in the opposite direction of expanding the regulated speculative position limits.

It is a major disappointment to the independent producer sector of the nation's largest industry of agriculture that a Congressional oversight investigation has not yet been ordered on this dereliction of responsibility by the CFTC.

Speculation in commodity futures is allowed as a legal practice under federal law for the purpose of shifting or assuming commodity ownership risk. Federal regulation of commodity futures speculation should then restrict speculation to the intended beneficial purpose of transferring ownership risk within a reasonable range of value reference established thru input costs.

If the CFTC cannot be responsive to the responsibility of regulation set out for it by the Congress then it is imperative that the Congress establish language in the Commodity Exchange Act that will serve as an in-place regulation rather than one calling on discretionary judgment of a commission.

In the interest of correcting this abandonment of responsibility set out for the CFTC by law the American Agriculture Movement has in three consecutive national annual conventions held in Washington, D. C.; Pueblo, Colorado; and St. Louis, Missouri developed and established a beneficial speculation rule for enactment into the Commodity Exchange Act to read in this form:

> It shall be unlawful for any person directly or indirectly to acquire a speculative net short position with contracts sold at a price below

> 90 percent of the USDA parity price or to acquire a speculative net long position with contracts purchased at a price exceeding 110 percent of the USDA parity price for any United States producer marketed agricultural commodity traded in futures on any contract market.

This rule is considered as falling well within the parameters of the authority of the CFTC to limit or abolish speculative short selling and yet not duly restrict trading except in those price ranges most detrimental to both producers and consumers. Furthermore, no budgetary consideration is necessary in enacting this safeguard.

Speculative short selling of commodity futures becomes economically devastating to U. S. agriculture when its use is allowed to stray away from the beneficial legal purpose of risk transfer because it represents the only known selling of a non-vested interest in a property. This selling is then used for the purpose of depressing the price of a commodity by so selling in concert with others and then buying the contract back at a lower price for a profit, thereby establishing a depressed reference price for the cash market. Commercial interests use this procedure to acquire cheap commodities.

The only way for production agriculture to counteract the sustained effect of this unjustified trading practice is to actually develop a national shortage of the commodity or to develop export markets that exceed the production capacity for the commodity. In either case export embargoes have been implemented. In the mean time the federal treasury pays target price deficiency payments to agriculture to try to subsidize its failing position in the market place due to speculative short selling.

Until a speculator first assumes an ownership interest in a commodity by first buying a contract, it is only then that he can assume an equivalent competitive position with a producer to offer a sale of the commodity. Remember, the farmers and ranchers were never asked if their commodities could be traded, speculated, and manipulated on a federally approved futures contract market.

Instead of the Congress terminating outright the cattle futures contracts because of their failure to serve an economic purpose it should consider the trading solution available thru the application of the beneficial speculation rule.

I have been asked to state that should the Congress not establish positive beneficial speculation regulation thru the Commodity Exchange Act the American Agriculture Movement, Inc. will consider filing an injunction against the passage of any further legislation relative to the CFTC until the regulatory failure stated herein is resolved.

(The following material was inserted by William F. Brooks, president and general counsel, National Grain Trade Council.)

March 30, 1973

STATEMENT
OF THE
NATIONAL GRAIN TRADE COUNCIL
ON SECTION 206 OF H. R. 6168

My name is William F. Brooks. I am President and General Counsel of the National Grain Trade Council. We appreciate this opportunity of registering our views against the approval, by House Committee on Banking and Currency, of Section 206 of H. R. 6168.

The stated purpose of this section is to prevent "excessive speculation in and the excessive use of credit for, the creation, carrying or trading in commodity futures contracts, havin' the effect of inflating consumer prices and industrial costs". To accomplish this, the Board of Governors of the Federal Reserve would prescribe regulations which apparently, would give the Federal Reserve System the same powers to set margin requirements in connection with trading in commodity futures contracts that it now holds in the setting of margins for credit transactions on the stock exchanges.

On a number of occasions Congressional committees have studied proposals which would grant to government officials authority to set margin requirements on futures transactions in commodities. We have opposed this grant of authority because in our considered judgment, no public official or group of public officials, such ar the Board of Governors, are so omniscent as to determine when speculation might become excessive in commodity transactions and to determine when any degree of speculation in commodity futures contracts would have the effect of inflating consumer prices.

We are convinced that speculative transactions have little effect on the price paid by consumers for commodities and that speculation is not a basic factor in determining the general level of prices in the long run. We doubt that it is an appreciable factor even in the short run and we are quite certain that reletively little credit is used in connection with futures trading.

The proposal embodied in Section 206 is based on a misconception of the nature of commodity contracts markets, on the nature of trading in commodity futures contracts, and on the functions of margins in connection with the commodity futures contracts when attempts are made to draw an analogy between them and the down payment required to obtain a title to stock or goods and chattels or real estate.

Organized contract markets are recognized commercial institutions. Most of the commodities for which futures trading is available, are subject to the Commodity Exchange Act. Additional commodities may become subject to this Act.

These recognized commercial institutions make possible an orderly movement of agricultural commodities from production to consumption. Their operations assure a rough equality on the buying and selling sides of the market. The availability of futures contracts makes substantial contributions to the financing of crops as they are planted, harvested, and start thereafter through the marketing channels to ultimate end users. Speculation within the commodity markets makes hedging possible and permits the operation of the Nation's low-cost efficient grain marketing system.

The grain marketing system, because of the availability of futures markets where people trade in futures contracts covering grain, is a highly competitive, low-cost marketing system. The function performed by futures markets is to register the forces of supply and demand by open public trading. In doing this through the medium of futures transactions, producers, processors, exporters, and others are offered an opportunity to obtain price insurance that today they may agree to deliver in the future something they may not now own, or that today they may agree to take delivery in the future of goods they may now anticipate they will need, or that today they may obtain a price certain for commodities they are buying or have bought and intend to carry awaiting sales or use for processing. Through trading on exchanges, a steady flow of commodities moves from production into consumption.

The rules of futures markets require that the users of these markets deposit collateral in the form of margins, to guarantee the performance of their contracts. The minimum margin to be deposited is determined by the governing boards of contracts markets. Futures commission merchants can and often do require deposits in excess of the minimum established by governing boards. The minimums required are subject to constant review. They vary by commodities, by type of trade, and may be different for different delivery months.

Attempts are at times made to draw an analogy between the margin required to enter into a contract for the future sale or purchase of a commodity, and the down payment required to obtain title to stock, or goods and chattels, or real estate.

There is no analogy between these transactions.

In speculative securities transactions actual title to the number of securities traded passes from the seller to the buyer. The speculator in securities deposits his own money in the amount required by the Federal Reserve Board to obtain title to the securities, and his broker then loans the balance, either from his own funds or from a lending bank to complete payment for the transactions. In speculative securities transactions actual title to securities, evidencing the acquisition or disposal of an equity, passes from a seller to a buyer.

So, too, as to transactions involving goods and chattels or real estate. There, purchasers obtain a title by making a down payment and arrange to pay the balance either with the seller or through a bank on terms satisfactory to the buyer, the seller, and the bank. The buyer receives a title to something tangible -something he can use-something he can deal with - subject, of course, to the rights of the lender - the seller or the bank - as those rights may be defined in a chattel mortgage or mortgage deed.

In transactions covering agreements to sell or buy commodities for future delivery or receipt, no title passes to the buyer and no title passes from the seller. Each party to such a contract entered into on a commodity exchange deposits with his broker an amount of earnest money to assure compliance with the contract when, in the future, it matures, or until an offsetting contract is entered into. Only if the contract is completed by delivery, when it matures, does a title pass. And then, contrary to the practice in transactions involving securities or goods and chattels or real estate, full payment must be made

Implicit in each futures transaction is an intention on the buyer's part to make delivery, and on the seller's part to take delivery. These obligations often are liquidated by offsetting trades. To the extent that they are not so offset,. delivery will be made by the seller and title to the grain covered by the contract will be accepted by the buyer.

The experience of late 1947 as to grain prices, indicates that in commodity markets, where the volume of speculative trading has been limited, prices react in response to supply and demand factors. In October of 1947, as demanded by the President, a 33-1/3 percent margin was set by the exchanges for speculative transactions. At that time May (1948) wheat at Kansas City was selling at $2.64-1/4. May wheat continued upward, reaching nearly $3.00. During this period the markets lost much if not all their liquidity, and such trades as were available to hedgers - processors or exporters, county and terminal handlers -- caused rather wide changes in prices.

No compelling public interest existed during World War II to require the Government to attempt to govern the margin requirements necessary to contract, as a speculator, for the purchase or sale of commodities for future delivery. It was not until April 1946 that the OPA attempted to exercise such authority. At that time this agency decreed that margins on new speculative trades in cotton futures should be $50 a bale on transactions based on a price above 28 cents a pound. If news stories describing the promulgation of this order are accurate, the then Secretary of Agriculture signed the order after he had been "ordered by Economic Stabilizer Bowles to sign it". Mr. Bowles at that time stated as the reason for the order "the prevention of further speculative rises in cotton". Why he then had to order the Secretary of Agriculture to sign is conjectural. The order to sign may have been required because the then Secretary of Agriculture believed then, as we do now, that it is not necessary but rather harmful and dangerous for the Government, through the exercise of control over margins in speculative contracts for future delivery, to interfere with the mechanism of free, open, competitive markets, and that attempts to control prices through this interference will not work.

It is significant that shortly thereafter, and before the decree became effective, Congress repealed the law under which the decree was issued.

This decision of Congress to remove (from the control sphere of the Government) control over margins was undoubtedly a decision based on full consideration of the merits of the question whether the Government should have authority to set margins on future transactions in commodities. Whatever the Congressional reason then, it is obvious that in view of subsequent legislative events, Congress has been consistently convinced thereafter that there was little or no merit in the request that the Government should have this authority.

In 1947 the Joint Committee on the Economic Report held extensive hearings on prices throughout the country and in Washington. During these hearings people connected with all segments of those industries that make use of futures markets testified on the operation of those markets. They explained the operation of those markets; the function of the speculator; the contribution he makes to a market's liquidity; the use of markets, in view of their liquidity, by producers, handlers,, processors, exporters, and others, in buying, storing, processing and exporting to insure inventories; and how, in view of these uses, sellers of the Nation's grains are not left to the mercy of a few or a single buyer; and buyers of the Nation's grains, as it moves from production into consumption, are not left to the mercy of a few or a single seller.

All opposed the suggestion that the Government should be granted the authority to set margins on speculative transactions. At that time, as now, the proponents of the suggestion stated that this authority was needed to prevent excessive speculation. They agreed then, and they agree now that futures markets, including speculation, perform an exonomic function in moving crops for, by them, hedging is possible. They agreed then and seem to agree now, that speculation is a stabilizing force and that its presence in open regulated market places "focuses all of the forces that affect price in one place where everybody can see it".

Since that date responsible committees of Congress have studied proposals to grant control to the Government to set margin requirements in connection with trading in commodity futures contracts.

In February 1948, the Senate Committee on Agriculture held hearings on a bill which, if enacted, would have granted margin control authority. Hearings on this bill (S.1881, 80th Congress, 2nd Session) extended over four days with a number of witnesses from the administration, the farm groups and industry interested in futures trading, appearing before the Committee. This Senate Committee after hearings and study of the testimony produced at these hearings, took no action.

In the 81st Congress, companion bills - H.R. 4685 and S.1751, embodying the same proposal, were referred to appropriate committees.

Neither bill was reported.

A Subcommittee of the House Committee on Agriculture was named to study H.R. 4685, and conducted an investigation into the operation of commodity exchanges. Thereafter this Subcommittee recommended that no new and additional regulation of commodity exchanges appeared nec essary.

In 1950 and 1951, in connection with the Defense Production Act and its extension, the House and Senate Committees on Banking and Currency, considered proposals to grant to the Government authority to set margins in connection with trading in commodity futures contracts. Congress did not approve the grant of this authority.

In 1966, a Subcommittee of the House Committee on Agriculture held hearings on a bill which would have granted a number of authorities to the Secretary of Agriculture, including the authority to set margins on commodity futures contracts. According to the U.P. ticker of April 6, 1966, Congressman Matsunaga, after the hearings had been concluded told newsmen that if this Committee approved any part of the bill it would only be in greatly modified form. The same news item reported that comments by other subcommittee members indicated the margin control section of the bill was not expected to survive.

That Subcommittee did not report a bill.

During the 90th Congress, a Subcommittee of the House Committee on Banking and Currency held hearings on H.R. 11601. Section 207 of that bill was nearly identical to the provisions of Section 206 of H.R. 6168 granting, as it does, certain authorities to the Board of Governors of the Federal Reserve.

After hearings directed specifically to Section 207 of H.R. 11601, the Subcommittee in 1967 made no recommendation that that proposal be reported favorably and acted on by Congress.

This Committee is, in effect, therefore considering a proposal which, in substance, has been considered by other committees and subcommittees in prior Congresses and found wanting. We recommend that this Committee make a similar finding.

We oppose this grant of authority because we are convinced that this method of attempting to prevent inflated consumer prices will not work. We oppose this grant of authority because an attempt by the government to exercise control over margins may well cause a breakdown in the entire marketing structure, leaving State trading as the only alternative. Raising margins will not keep prices from going up. It seems to be admitted that commoditi4s that have no futures market are usually more erratic in price than those that have. By raising margins you can reduce and eliminate volume of trading. But you cannot control prices. And, you might wreck the market structure.

STATEMENT BY WILLIAM G. LESHER

ASSISTANT SECRETARY FOR ECONOMICS
U.S. DEPARTMENT OF AGRICULTURE
BEFORE THE SENATE COMMITTEE ON AGRICULTURE,
NUTRITION, AND FORESTRY
SUBCOMMITTEE ON AGRICULTURAL RESEARCH AND GENERAL LEGISLATION
March 10, 1982

Mr. Chairman and Members of the Committee, I am very pleased to appear before this Committee today to discuss the importance of futures trading to agriculture, to support generally the reauthorization of the Commodity Futures Trading Commission (CFTC) and specifically to support lifting the ban on trading in options on farm commodities.

Futures markets provide forward pricing and hedging mechanisms that greatly facilitate the efficient marketing of farm products. The prices generated on futures markets are widely used as indicators of value and as guides for production and storage decisions by farmers and other businessmen. And the shifting of risk provided by active forward markets greatly aids the mobilization of capital in production and marketing.

But futures trading is subject to various abuses. Experience has shown that effective regulation at the Federal level is needed to protect producers and other traders. The Department of Agriculture strongly supports the reauthorization of the CFTC to provide this protection.

I would like now to explain why we feel that the prudent introduction of options trading for farm commodities could benefit farmers, others in agriculture and the general public. After a brief overview of options trading, popularly known as "puts" and "calls" trading, I shall identify some of the issues involved. The reasons options trading was banned in 1936 will be reviewed, and the differences between past options trading and what is envisioned will be described. The relation between options trading and price supports, the possible benefits to farmers from options trading by marketing firms, and the potential problems with options trading will also be discussed.

OVERVIEW

Farmers, especially small and medium size operators, might benefit substantially from well-functioning commodity options markets for crops and livestock. Options trading could increase efficiency in agriculture by facilitating more effective risk transfer. While it may take some time before viable agricultural options markets develop because certain issues will have to be addressed and resolved, no progress can take place until the ban is lifted.

The main reason for banning options trading in 1936 was to stop abusive practices. While abuses did occur in the past, it seems that the ability of both the commodity exchanges and the CFTC are adequate to ensure that similar abuses would not occur today. The potential problems of options trading do not appear to be insurmountable and only could be solved after the ban is lifted--but before trading is allowed. In view of the potential usefulness of options trading to agriculture, yet great uncertainty over how far this potential could be realized, the Department of Agriculture recommends the removal of the 1936 ban on agricultural options trading, subject to the understanding that such trading would not start until after the CFTC and the commodity exchanges have completed their pilot program with options trading of other commodities, evaluated its feasibility, and developed procedures that are essential for effective control of trading abuses.

THE ISSUE

In the face of fluctuating farm prices, farmers have a difficult time deciding what to produce and when to sell. Larger operators usually are better positioned to use futures (either directly or indirectly) to plan production and to price their products before harvest. Being larger, they can spread trading costs over greater volume. More importantly, they can better master the intricacies of futures trading such as avoiding undue losses attending crop failure, shifting hedges among delivery months, arranging adequate margin funds, borrowing against hedged positions, and so on. Smaller operators often feel confined to accept the price at the time the crops or livestock are ready for market, whatever the price happens to be.

Local dealers might offer smaller farmers cash contracts and, thus, avoid the need for the farmers to deal in futures. However, the dealer's margin may be too wide to be acceptable. Also, there is a risk that the dealer would not live up to his contract. More importantly, many farmers would like to profit from price increases. In this setting, a well-functioning agricultural commodity options market could improve the farmer's chances of getting better prices without, at the same time, binding the farmer to delivery of the commodity. The latter condition is particularly important when farm output is uncertain.

Thus, with options trading the farmer could buy the right to sell ("put") specified amounts of a given commodity to a second party at a stated price ("striking price") for which right he or she pays a sum of money ("premium"). But he or she need not exercise that right (all or in part) if the market price rises, or if yields are short, or both. When output risk is absent, or in its presence when combined with yield insurance, put options could protect farmers from much of the downside price risk in crop and livestock production.

The past year provides a dramatic example of the potential gains from options trading. For example, the price of corn to North Central Indiana farmers for harvest-time delivery declined from $3.39 per bushel in April to $2.36 per bushel in November--or about a dollar a bushel. Options trading would have allowed farmers to protect themselves from this decline. They would pay others some fraction of a dollar for the privilege of selling them the corn at harvest for a specified price--$3.25 per bushel, for example.

The purchase of a call option is similar but it would be used by farmers and others who wish to assure themselves of a maximum price they would have to pay for commodities they plan to use--for example, in feeding livestock, exporting grain, and so on.

Farmer protection from price declines through purchase of put options might have been accomplished by selling futures contracts instead. Certain strategies in using futures are available--like selling only part of the expected crop forward at planting time, or the use of "stop-loss" futures purchase orders--but none of these measures assures the same straight-forward results as the farmer's purchase of a put option for his entire crop. Moreover, the great majority of farmers are not of sufficient size, or sophistication in the ways of futures trading, to avoid pitfalls. With the purchase of an option, a farmer would know what the total cost of his risk protection would be ahead of time, and would not be subject to any margin calls.

In general, options might be traded in the underlying commodity or in futures contracts which call for delivery of the underlying commodity. There is little need to distinguish between the two in discussing the general economic role for agricultural producers. But it should be recognized that active options trading in the underlying commodity presupposes two conditions that are also required for futures trading, namely, low transaction costs and high contract integrity. Low transaction costs require trading in a competitive market and extreme standardization of contract terms, such as standard location, grade, quantity, exercise date and the striking price or the premium. High contract integrity requires an uncompromised system of performance guarantees. Thus, it appears reasonable either to base options trading on commodity futures contracts or on commodities similarly standardized, and place such trading on the commodity exchanges.

Whether many farmers would actually hedge their market risks in commodity options would depend on the premium that would be charged by options grantors for a given level of downside price protection--a matter that only experience would determine. But options trading in the major farm commodities--grains, oilseeds, livestock, cotton, potatoes, among others--has been prohibited by Federal law since 1936. Therefore, one cannot develop any realistic opportunities for farmers without lifting the 1936 ban.

THE 1936 BAN ON TRADING

In 1936, after many decades of controversy, trading in options was outlawed for commodities regulated under the Commodity Exchange Act--notably the grains and cotton, among others. This ban ended options trading that had flourished on commodity exchanges since 1926, at which time the Supreme Court invalidated a prohibitive tax of 20 cents that had been levied in 1921 on every bushel of grain involved in puts and calls trading.

The 1936 Act did not ban options trading in unregulated commodity futures, such as for coffee, sugar, cocoa, gold and silver. Nor did it ban trade in dealer options or foreign options. Subsequently, the 1974 Act gave the CFTC exclusive jurisdiction over all commodity options and authorized the CFTC to determine whether and how such trading should be permitted. The spread of unsound and fraudulent practices in selling London and dealer options, and the difficulty the CFTC experienced in controlling these practices, caused the agency to suspend such off-exchange trading in 1978. However, the CFTC has recently announced a pilot program in options trading in a few selected commodities, not specifically banned by legislation, to take place under the rules and regulations of the commodity exchanges.

There are three main reasons why a ban on trading in agricultural commodity options was placed into effect in 1936:

1. There was a residue of strong 19th century attitudes, carried over into the 20th century. Futures trading had been under attack for many years as a form of gambling, because most futures contracts were offset and physical delivery of the commodity was not required. The defense against the gambling charge is that all futures contracts require physical delivery if either party should wish it. But this defense could not be made for trading in puts and calls (which were periodically traded beginning in the 1860's) because the essence of such contracts is that delivery is optional with the buyer. Thus, the defense of options trading against gambling laws was always on weak legal grounds. For example, in a 1922 decision in respect to the 1921 Futures Trading Act, the Supreme Court described puts and calls as transactions "which approximate gambling or offer full opportunity for it."

   Since then, attitudes and legal interpretations have changed to the point that in December 1981 and February 1982 futures contracts were approved by the CFTC requiring cash settlements instead of physical delivery after trading has stopped. This is a complete reversal of the age-old concept of futures as a binding delivery instrument.
2. Trading puts and calls had been used by some traders for manipulative or fraudulent purposes--enticing people of limited means as option buyers, to their later regret. Characteristically, options trading (variously called privileges, indemnities, bids, offers, puts, calls, advance guarantees and decline guarantees) was listed in the 1936 Act immediately after wash sales, cross trades, and accommodation trades as prohibited practices. The question here is whether these problems would become unmanageable under modern regulatory procedures.
3. There was an expressed view that trading in options needlessly accentuated price movements in the commodity. For example, in 1933 trading in puts and calls was suspended by exchange action after the price collapse of July 19-20. Representatives of the grain exchanges stated that the elimination of such trading "removed one of the prime causes of excessive price movements." And they pledged to try to keep the elimination permanent.

   Apart from manipulative influences alluded to above, there is no clear reason to believe that trading in commodity options would have more of an adverse rather than a beneficial effect on commodity prices. This is the same observation that can be made about the effect of futures trading on cash commodity prices. Most studies, to date, do not point to net adverse effects.

BASIC DIFFERENCE BETWEEN PAST OPTIONS TRADING AND WHAT IS ENVISIONED

The agricultural options that were traded before the 1936 ban were essentially short-term--mainly one-day, two-day or one-week options (then called "privileges"). These options mainly interested professional speculators, pit traders--not merchandising firms nor, least of all, farmers. The premium was fixed and the striking price varied by bargaining.

The options trading now envisioned would cover significant periods from the standpoint of farm production, for example, 2, 4, and 6 months. And the bargaining might well be focused on the premiums for a given striking price, which is similar to stock options.

Second, the agricultural options traded before 1936 were mainly confined to grains and cotton where futures trading was very active. Now options trading appears applicable to more products--in particular, it appears especially suited to cattle, hogs, and potatoes, among others.

Finally, the agricultural options trading before 1936 was, at various times, conducted on and off the exchanges. Even when conducted on the exchanges, there were not always clearing-house guarantees of performance, as now envisioned for an effective market in agricultural options.

RELATION OF OPTIONS TRADING TO PRICE SUPPORTS

For an individual farmer, the purchase of a put option has some similarities to entering into a price support agreement with the CCC, except that the farmer rather than the taxpayer would bear the cost of reducing the exposure to a significant price decline. Options trading would not be as attractive to most farmers as price supports, assuming other conditions were equal--the support price equals the striking price, no restrictions on plantings, or other factors.

Because price supports and commodity options generally serve the same purpose for an individual producer, the farmer's use of options would largely depend on how close support prices were relative to market prices. The same thing is true of the use of futures contracts, as the history of cotton and grain markets indicates. Thus, the rise of options trading depends on Government policies. Since price supports are normally below market-clearing levels to avoid interfering with our share of international trade, many farmers--especially those who are young or highly leveraged or both--may desire to reduce their risk at a price much higher than the price support level. This is especially true since agricultural markets have become much more variable in recent years.

Unlike agricultural options, however, the price support program provides a floor, nationally, for certain farm commodities. In addition, an options market could function efficiently for farm products other than storables, such as livestock. The main requirement is fungibility and unmonopolized supplies--the same conditions required for successful futures trading.

INDIRECT BENEFITS TO FARMERS OF OPTION TRADING BY MERCHANTS AND PROCESSORS

Without options, the grain exporter who is searching to make deals abroad is exposed to an unanticipated rise or decline in domestic grain prices, while negotiating a price with importers. In view of such hazards, the preferred course of action is to acquire grain inventories, or commitments to buy grain, and hedge them in futures, followed by an offer to sell grain to importers on "basis on or off futures."

The success of this method depends on having a well-functioning futures market--sufficiently liquid for consummating large export deals without moving price appreciably against oneself. Some evidence suggests that grain futures markets have not always been adequate in this respect (see Heifner, et. al., A Study of Relationships Between Large Export Sales and Futures Trading, 1979).

With current high interest rates, much of the speculative interest in grain futures has moved to other investments, and the situation may have worsened. Hence, an options market might offer a means of meeting the grain exporters' needs, assuming it can develop the necessary liquidity.

The exporter could estimate more accurately the costs of acquiring the grain for export without being firmly committed to an uncovered long position in grain (or in grain futures). Thus, for example, the exporter could buy a 30-day call on the quantity of grain that it thinks it can sell abroad at a stated price. For this right, it pays the opposite party a sum of money, whether or not it exercises the call. The cost of the grain to the exporter then would be the stated price of grain plus the cost of the option. Having established such a position, the exporter presumably would be better able to determine a minimum offer price to grain importers, taking into account estimated transportation costs and other factors.

Farmers would benefit indirectly if there were improved trading opportunities for exporters who then could (1) increase the volume of grain exports and (2) lower the margin that exporters now figure that they need to have to meet uncertain grain acquisition costs.

POTENTIAL PROBLEMS

Although we feel there is a potential for agricultural options, there are also some potential problems which can be briefly stated.

1. It is unclear whether options trading would compete with or complement futures trading. To the extent there is, at any one time, a limited speculative fund for agricultural products, the addition of another means to speculate could grow only at the expense of existing means. This might disadvantage existing futures trading and be of no service to farmers or middlemen on whom farmers depend for marketing their produce.

   One possible disadvantage of options trading is that the number of contracts needed are several times the number of futures contracts required to serve the same market. This would occur because a separate option contract is required for each different striking price. It means either that more speculators are required to provide liquidity or some options would be very lightly traded. However, active trading could cluster around certain striking prices.

However, in the longer run, new financial instruments tend to broaden their own markets by developing classes of specialized intermediaries who use the different instruments—each according to its own best employment--and may take spread positions between the two instruments. Indeed, the business of granting options would grow only as grantors found ways of limiting their loss exposure, which probably means covering net option positions in futures when commodity prices move against them. Thus, a healthy options market probably depends on a healthy futures market. To the extent futures trading and options trading serve different purposes, it would require prolonged market testing to judge the degree to which their growth is interdependent.

2. A possible disadvantage of put options would be a higher cost than most farmers are willing to pay. In the grain futures market, exporters and processors, through their long hedging, balance some of farmers' short hedging, thereby keeping risk premiums small. But in an options market, farmers would buy puts from speculators while exporters and processors would buy calls from other speculators. Substantial risk premiums might result. In effect, farmers might be paying too much for a price floor and, thus, not use options. However, to the extent option dealers cover their net positions in futures markets, the speculative positions in futures might shoulder much of the risk. In addition, commercial traders may also buy and sell options. Only experience would tell.
3. Option trading might cause some large traders to increase their open positions in a commodity via purchase of options and thus add to the problem of countering squeezes in futures contracts deliverable on options. This potential problem would be true whether the options called for delivery of futures or of the underlying commodity. However, squeeze potentials might not be increased significantly if the options were exercisable somewhat before futures contracts come due.

   Another safeguard against increasing squeeze potentials through options trading is to place limits on the positions in futures and options combined (for example, combine the rights to "call" with long futures; combine the rights to "put" with short futures). In addition, speculative limits could be used.

RETROSPECT ON EVOLVING MARKET ARRANGEMENTS

History teaches that market arrangements are not perfected overnight. Rather, they evolve from pre-existing arrangements as fundamental conditions change, forcing the abandonment of some methods, and engendering the coming of others. Indeed, the history of the economic development of western civilization over many centuries is, in a real sense, a history of the rise of markets and their progressive adaptation to change. In essence, the rise of markets depends on discovering better ways to define rights in property; establish their negotiability through changes in attitudes, custom and law; and provide specialized services, and rules governing the exchange of claims, in line with needs and preference of more and more people.

The development of agricultural options trading should be judged in this context. For such trading to serve business needs efficiently and with integrity, experimentation is required. In a sense, organized futures trading itself has been going through a long experimental process to this day. We sometimes take for granted the current futures trading procedures as if they were always there--for example, the daily cancellation of offsetting contracts, use of delivery notices, substitute delivery, the modern clearing house corporation, and so on. But each of these arrangements was a long time in coming. The machinery for futures trading is still evolving, as we now see with the recent adoption of cash settlements in lieu of delivery for some contracts.

The time seems ripe to start the process of searching for suitable arrangements to promote agricultural options trading in view of the highly unstable market conditions that agriculture faces and must somehow adjust to.

STATEMENT OF HOWARD A. STOTLER

IMMEDIATE PAST CHAIRMAN

FUTURES INDUSTRY ASSOCIATION, INC.

BEFORE THE

SUBCOMMITTEE ON AGRICULTURE RESEARCH AND GENERAL LEGISLATION

SENATE COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY

MARCH 10, 1982

Mr. Chairman and members of the subcommittee, my name is Howard A. Stotler. I am appearing here on behalf of the Futures Industry Association, Inc. I am a Director and immediate past Chairman of the Board of Directors of that Association. In addition, I am Managing Partner of Stotler and Company, a registered Futures Commission Merchant, a Partner of Stotler Grain Co., a cash grain merchant, and a provisional director of the National Futures Association.

FIA is the national trade association of the commodity futures trading industry, with 200 members. Our regular membership is comprised of 87 of the nation's leading futures commission merchants which handle an estimated 80 percent of all futures contracts traded on U.S. exchanges on behalf of members of the public. In addition, FIA has 113 associate members, including all of the domestic futures exchanges and a number of banks, law and accounting firms, commercial users of futures markets, farm organizations, commodity trading advisors, commodity pool operators and others with an interest in futures trading.

The purposes of FIA are to act as a spokesman of behalf of the futures industry; to increase public knowledge of the economic purposes of futures trading; to encourage public use of the futures markets; to maintain high ethical standards in the futures industry; to assemble, preserve, and furnish to its members, exchanges, and the public accurate and reliable information and statistical data regarding futures trading; and, in general, to facilitate the exchange of ideas with exchanges, members of FIA, and the federal and state governments in order to promote and preserve free futures markets.

We are pleased to have this opportunity to offer our views on legislation reauthorizing funding of the Commodity Futures Trading Commission and amending the Commodity

Exchange Act.

The scope of the futures trading industry is indicated by the record 98.5 million futures contracts traded on U. S. futures exchanges in 1981. This compares with only 58 million in 1978 when the CFTC was last reauthorized. Volume of trading in the futures markets has increased for 14 consecutive years. A report covering futures volume figures for 1981, with comparisons with prior years, is included as an appendix to my statement.

While many stress the spectacular growth in financial futures trading over the the past several years, it is important to bear in mind that trading in agricultural commodity futures accounted for slightly over half of the total number of contracts traded in 1981 and except for the record year of 1980, was at an all time high.

REAUTHORIZATION OF CFTC

The Futures Industry Association strongly supports the reauthorization of funding for the CFTC in its present form. FIA believes that Congress correctly determined in 1974 that all futures trading should be regulated by a single independent Federal regulatory agency rather than by a multiplicity of state and federal agencies. Congress felt that a coherent regulatory policy developed by a single agency would best serve the public interest. The reasons for Congress' action at that time were valid. They continued to be valid in 1978 when Congress reauthorized the funding of the CFTC, and nothing has occurred since that time which should cause Congress to change that determination. While FIA has been critical of certain aspects of the CFTC's performance, we believe its performance has improved markedly under the leadership of its present chairman.

We suggest that Congress consider extending the period between reauthorizations of the Commission's funding authority to 6 years.

JURISDICTION

FIA believes that the extent of the exclusive jurisdiction of the CFTC should remain unchanged. However, we consider the jurisdictional compromise reached between CFTC Chairman Johnson and SEC Chairman Shad as being acceptable. While we might draw the dividing line separating the jurisdiction between the two agencies differently, the compromise represents a division within the range of reasonableness, and it appears to be in the best interest of all concerned not to have two agencies of the Federal Government engaged in a turf battle when the heads of those agencies have worked out a compromise that is acceptable.

With the exception of two limited areas, we have no quarrel with CFTC's proposal to restrict its exclusive jurisdiction to activities involving or concerning transactions on contract markets or those regulated by the Commission under sections 4c and section 19 of the CEAct. First, the Commission should continue to have exclusive jurisdiction over activities in the United States which involve transactions on foreign futures markets. Second, we believe it should be made clear that the granting of a role to the SEC with respect to the formation of commodity pools does not grant such a role to the states and that the states have no jurisdication to impose state standards on any activities involving commodity pools.

Futures trading is world wide. While we, here in the United States, are the leaders in the industry, there is every indication of continuing foreign growth in futures market activity. There will be more and more reason for persons in this country to enter into transactions on foreign exchanges. In considering the Commodity Futures Trading Commission Act of 1974, the Congress recognized the inefficiencies involved in having over 50 possible regulatory authorities in this country. Therefore, Congress made it clear that in the grant of jurisdiction to the Commodity Futures Trading Commission, the words "any other board of trade, exchange, or market" were included for the purpose of giving the CFTC exclusive jurisdiction over futures contracts purchased and sold in the United States and executed on foreign exchanges. We see no reason to change this determination and, in fact, believe it would be unwise to do so.

Because we believe the Commission should retain its exclusive jurisdiction over activities in the United States involving foreign futures trading, it is our view that the proposed narrowing of the definition of the term "commodity trading advisor" should not exclude from that term persons whose advices concern trading on foreign futures markets.

While we grudgingly acceed to CFTC's proposal to recognize that the Securities and Exchange Commission has a role in the sale of commodity pool interests, we believe it is necessary to make clear that no role of any kind has been given to the states. Despite the limitations Congress has imposed on state authority, some state agencies have attempted to impose state standards on commodity pool activities which are inconsistent with those imposed by CFTC. Commodity pool activity has been expanding greatly as more and more investors acquire commodity pool interests as a means of participating in futures trading with limited risk. It should be made clear that this activity is not subject to a multiplicity of regulation.

MARGINS

In recent years there have been proposals to vest margin authority over futures trading in either the CFTC, the

With the exception of two limited areas, we have no quarrel with CFTC's proposal to restrict its exclusive jurisdiction to activities involving or concerning transactions on contract markets or those regulated by the Commission under sections 4c and section 19 of the CEAct. First, the Commission should continue to have exclusive jurisdiction over activities in the United States which involve transactions on foreign futures markets. Second, we believe it should be made clear that the granting of a role to the SEC with respect to the formation of commodity pools does not grant such a role to the states and that the states have no jurisdication to impose state standards on any activities involving commodity pools.

Futures trading is world wide. While we, here in the United States, are the leaders in the industry, there is every indication of continuing foreign growth in futures market activity. There will be more and more reason for persons in this country to enter into transactions on foreign exchanges. In considering the Commodity Futures Trading Commission Act of 1974, the Congress recognized the inefficiencies involved in having over 50 possible regulatory authorities in this country. Therefore, Congress made it clear that in the grant of jurisdiction to the Commodity Futures Trading Commission, the words "any other board of trade, exchange, or market" were included for the purpose of giving the CFTC exclusive jurisdiction over futures contracts purchased and sold in the United States and executed on foreign exchanges. We see no reason to change this determination and, in fact, believe it would be unwise to do so.

Because we believe the Commission should retain its exclusive jurisdiction over activities in the United States involving foreign futures trading, it is our view that the proposed narrowing of the definition of the term "commodity trading advisor" should not exclude from that term persons whose advices concern trading on foreign futures markets.

While we grudgingly acceed to CFTC's proposal to recognize that the Securities and Exchange Commission has a role in the sale of commodity pool interests, we believe it is necessary to make clear that no role of any kind has been given to the states. Despite the limitations Congress has imposed on state authority, some state agencies have attempted to impose state standards on commodity pool activities which are inconsistent with those imposed by CFTC. Commodity pool activity has been expanding greatly as more and more investors acquire commodity pool interests as a means of participating in futures trading with limited risk. It should be made clear that this activity is not subject to a multiplicity of regulation.

MARGINS

In recent years there have been proposals to vest margin authority over futures trading in either the CFTC, the

the staff did not try to identify either costs or benefits.

The so-called "user fee", like any tax on commercial activity, is
to some extent shiftable. This is especially true for agricultural commodity futures which facilitate the movement of basic commodities from the farmer to the consumer. If a transaction tax is imposed on futures, the ultimate payer may be the farmer, the consumer, or both-but no one has bothered to find out! We believe it essential that the economic impact of the tax, the impact on the futures markets, on the direct users of the markets and on the hundreds of thousands who depend on those markets to facilitate the marketing of their production, by price discovery and risk shifting, be thoroughly examined before such a tax is even considered. These markets are not like the stock markets where the only users are the buyers and sellers of stock.

We reject the notion advanced by some "user fee" proponents that the spectacular growth of our industry would not have occurred without the existence of the CFTC, as if CFTC regulation were some type of subsidy to the futures industry. Our industry growth has resulted from changes in the economic climate which have increased risk in the market place and from the ingenuity of the industry in developing new products to meet the needs brought about by those changes.

While FIA is opposed to the so-called "user fee" concept, this does not mean we are insensitive to the need to reduce Government expenditures. We fully support the National Futures Association ("NFA"),an industry self-regulatory association licensed by the CFTC which, in the near future, will take over from the Commission many of the activites designed to protect the market user. These are the activities which can be identified as those being done for the benefit of the market users. With the advent of NFA, it would make no sense for the CFTC to impose charges on market users to cover the costs of activities which are scheduled to be taken over by the industry self-regulatory organization in the not too distant future. If the so-called "user fees" are imposed, there is good reason to believe that NFA will die aborning. Why should the industry pay twice for the same services? It makes more sense to let an industry self-regulatory association assume the functions it is better able to perform and to reduce CFTC expenses as that association gets underway.

AUTHORITY FOR RULE MAKING REGARDING FOREIGN FUTURES CONTRACTS

While FIA is of the view that the CFTC should continue to have exclusive jurisdiction over activities in the United States which involve transactions on foreign futures markets, we believe its proposal for authority for rule making regarding such activity, as contained in proposed section 4(b), is much too broad. CFTC proposes that it be given unlimited authority to adopt rules and regulations governing the offer and sale of foreign futures contracts by persons located in the United States. FIA believes a more appropriate grant of authority would be achieved by including in the CEAct, the language contained in present CFTC regulation 30.02 "Fraud in connection with transactions in futures contracts other than on domestic contract markets."

INTRODUCING BROKERS

FIA opposes the CFTC proposal to "deemphasize the 'agent' category" and to treat persons presently in that category in all respects as associated persons of futures commission merchants.

Ever since there has been futures trading, there have been introducing brokers engaged in soliciting and accepting commodity futures business. They deal with their customers much like an FCM except that the customers' trades are cleared and funds are deposited with an FCM. In many instances, such a person has been someone engaged in marketing agricultural commodities who deals in futures in connection with his cash business and started handling futures orders from those with whom he dealt in his cash business. In other instances, introducing brokers have been security firms who do not handle enough futures to become futures commission merchants or have been small firms getting a start in the business who do not have sufficient capital to become futures commission merchants or do not have sufficient business to warrant the cost of operating as an FCM. Over the years, these introducing brokers have been reported by FCMs to the CFTC as agents and FCMs have been responsible for their acts within the scope of any authority the FCM has given them. Now, CFTC wishes to eliminate introducing brokers entirely and treat them as though they were employees of the FCMs. This change, especially in light of the CFTC's "controlling person" proposal, which I shall come to later, appears to greatly increase the liability of the FCM and its principal officers and partners for the acts of people over whom, as the way business is now conducted, the FCM and it's managers have extremely limited control. I am afraid that if CFTC has its way, this means the end of the introducing broker category and the demise of many small firms throughout the United States and especially in the agricultural areas.

LIABILITY OF "CONTROLLING PERSONS"

FIA strongly opposes the CFTC proposal to amend section 13 of the CEAct to make the aiding and abetting provisions applicable to judicial as well as to administrative proceedings and to add a paragraph (b) which would provide that "any person who, directly or indirectly, controls any person who violates any provision of this Act or any of the rules, regulations, or orders issued pursuant thereto, may be held responsible for such violation as a principal, unless the controlling person did not know or, in exercise of reasonable care, did not have reason to know of the facts constituting the violation."

Section 13 (a) of the Act provides that one must act willfully before he can be held as a principal for aiding or abetting the commission of a violation of the Act. The proposed paragraph (b) would remove the "willfully" standard insofar as "controlling persons" are concerned. For this one class of persons, they could be found guilty of a violation of the Act, merely because of simple negligence; merely because they failed "in the exercise of reasonable care". What is "the exercise of reasonable care"? It means different things to different people. How often during the press of business do we make a decision that in hindsight we wonder why we made it? Could that not be called, in hindsight, failure in the exercise of reasonable care? CFTC proposes to make human frailty a crime.

When Congress added section 13 to the CEAct, it considered carefully the question of whether the word "willfully" should be included and correctly decided that it should be. There was no reason then and there is no reason now to hold a "controlling person" or any other person guilty as a principal for a violation unless that person acted willfully.

This proposed change is especially troublesome because of what the Commission proposes to do about introducing brokers. Under the proposed change in section 13 the head of the commodity department of a large futures commission merchant could be held to have violated the Act because of the actions of an employee of an introducing broker. If that employee embezzles customer's money, the head of the commodity department of the carrying broker may, under section 8a of the Act, have his registration revoked. He may be disqualified to continue to work in the industry. Further, under the proposed amendment to section 9(a) of the CEAct, he may be found guilty of a felony.

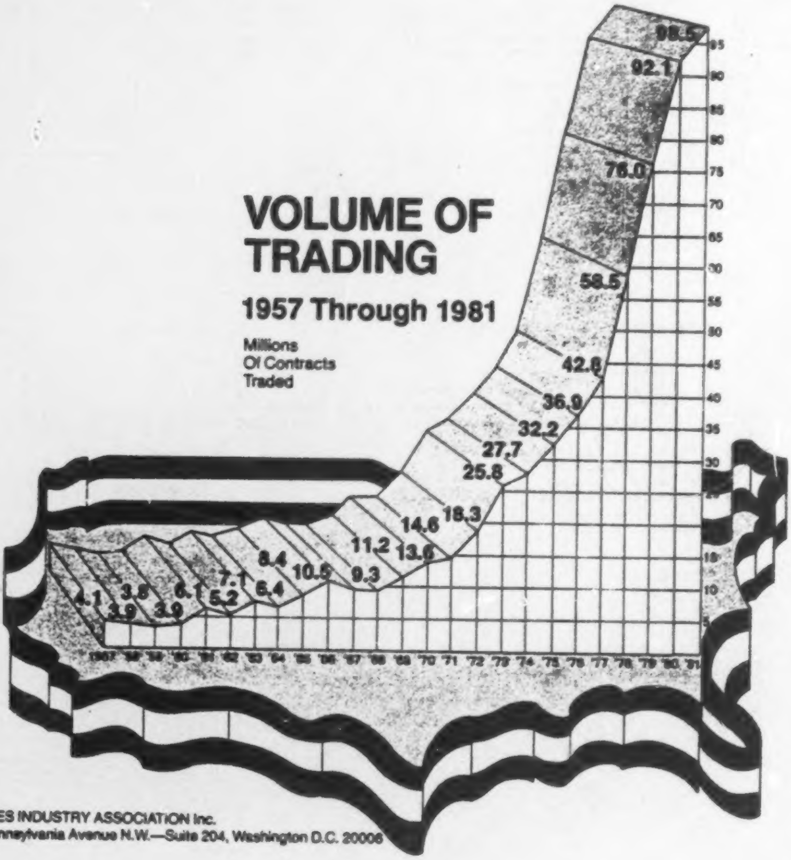
We are not suggesting that the customer have no recourse, since the firm employing the offender would still be liable to the customer.

ASSOCIATION WITH A PERSON SUBJECT TO STATUTORY DISQUALIFICATION

The CFTC proposes to add a paragraph (5) to section 4k of the CEAct to make it "unlawful for any registrant to permit a person to become or remain an associated person of such registrant, if the registrant knew or should have known, of facts regarding such associated person that are set forth as statutory disqualifications in section 8a(2) of this Act." Upon turning to section 8a(2) as proposed by CFTC you will find that it would provide that upon notice but without a hearing the Commission would be authorized to refuse to register, to register conditionally or suspend, or place restrictions upon the registration of a person if certain statutory disqualifications exist. Under this section the Commission may or may not proceed against the person and it may register the person conditionally or under restriction. However, under section 4k(5) it appears that it would be unlawful for an FCM to permit any such person to be an associated person of the registrant under any condition. FIA questions whether the Commission has adequately thought out the whole matter of statutory disqualifications. Perhaps this whole concept should go back to the drawing board.

FIA supports the principles and objectives of the "Futures Trading Regulatory Improvements Act of 1982" and the NFA's legislative recommendations.

Thank you very much for your time and attention. I would like at this time to ask that you leave the record open for any additional comments we may have on issues raised at these hearings. I will be glad to respond to any questions you may have.



FUTURES INDUSTRY ASSOCIATION Inc.
1919 Pennsylvania Avenue N.W.—Suite 204, Washington D.C. 20006

VOLUME HIGHLIGHTS

	Rank	COMMODITY GROUP		Contracts		%
1981	1.	Agricultural Commodities		50,381,053		51.15
		Grain	17,915,628		18.18	
		Soybean Complex	17,531,221		17.79	
		Livestock, Products and Poultry	9,406,607		9.55	
		Imported Agricultural Commodities 1/	3,462,613		3.51	
		Other Agricultural Commodities 2/	2,064,908		2.10	
	2.	Financial Instruments		22,864,613		23.20
	3.	Precious Metals		15,690,495		15.93
	4.	Foreign Currency		6,122,082		6.21
	5.	Non-Precious Metals		1,647,303		1.67
	6.	Petroleum Products		1,005,160		1.02
	7.	Lumber Products		811,665		.82
		TOTAL		98,522,371		100.00
		*	*	*		*
1980	(1)	Agricultural Commodities		59,134,754		64.2
		Grain	20,349,023		22.1	
		Soybean Complex	19,207,489		20.9	
		Livestock, Products and Poultry	11,639,519		12.6	
		Imported Agricultural Commodities	4,886,416		5.3	
		Other Agricultural Commodities	3,052,307		3.3	
	(3)	Financial Instruments		12,469,878		13.5
	(2)	Precious Metals		13,171,816		14.3
	(4)	Foreign Currency		4,222,820		4.6
	(5)	Non-Precious Metals		1,848,100		2.0
	(7)	Petroleum Products		238,309		0.3
	(6)	Lumber Products		1,010,424		1.1
		TOTAL		92,096,109		100.0
		*	*	*		*
1979	(1)	Agricultural Commodities		46,836,683		61.6
		Grain	14,534,603		19.1	
		Soybean Complex	15,808,411		20.8	
		Livestock, Products and Poultry	11,902,203		15.7	
		Imported Agricultural Commodities	2,510,179		3.3	
		Other Agricultural Commodities	2,081,287		2.7	
	(3)	Financial Instruments		5,607,005		7.4
	(2)	Precious Metals		18,163,696		24.0
	(5)	Foreign Currency		2,222,978		2.9
	(4)	Non-Precious Metals		2,301,108		3.0
	(7)	Petroleum Products		33,894		–
	(6)	Lumber Products		801,107		1.1
		TOTAL		75,966,471		100.0

1/ Excludes Imported Beef

2/ Cotton, Eggs, Orange Juice, Potatoes and Sunflower Seeds

VOLUME HIGHLIGHTS

1981 in Comparison with 1980

		1981		1980		
Rank	EXCHANGE	Contracts	%	Contracts	%	Rank
1.	Chicago Board of Trade	49,085,763	49.82	45,281,571	49.18	(1)
2.	Chicago Mercantile Exchange	24,527,020	24.89	22,261,295	24.17	(2)
3.	Commodity Exchange, Inc.	13,293,049	13.49	11,009,389	11.95	(3)
4.	Coffee, Sugar & Cocoa Exchange	3,562,613	3.62	4,886,416	5.31	(4)
5.	MidAmerica Commodity Exchange	2,588,540	2.63	2,993,636	3.25	(5)
6.	New York Cotton Exchange	1,802,891	1.83	2,653,294	2.88	(6)
7.	New York Mercantile Exchange	1,781,407	1.81	1,154,905	1.25	(8)
8.	Kansas City Board of Trade	1,181,884	1.20	1,298,047	1.41	(7)
9.	Minneapolis Grain Exchange	372,624	.38	360,978	.39	(9)
10.	New York Futures Exchange	290,585	.29	183,993	.20	(10)
11.	New Orleans Commodity Exchange	35,995	.04	-	-	-
12.	AMEX Commodity Exchange	-	-	12,585	.01	-
		98,522,371	100.00	92,096,109	100.00	

COMMODITY FUTURES CONTRACTS TRADED 1977 - 1981

	CONTRACT UNIT	1981	1980	1979	1978	1977
Wheat	5,000 bu	4,511,934	5,428,160	3,575,395	2,956,134	1,820,790
Corn	5,000 bu	10,674,986	11,946,975	8,671,719	6,127,099	5,021,827
Oats	5,000 bu	370,103	320,934	215,928	215,774	109,970
Soybeans	5,000 bu	10,489,932	11,768,197	9,114,348	8,477,277	7,996,139
Soybean Oil	60,000 lb	3,047,490	3,167,895	3,081,646	2,909,284	2,535,046
Soybean Meal	100 tons	3,039,633	3,218,690	2,647,821	2,493,086	2,373,453
Iced Broilers	30,000 lb	-	4,079	25,681	74,684	64,938
Silver	5,000 oz	214,236	341,033	2,720,589	2,657,833	2,257,059
Silver	1,000 oz	184,776	-	-	-	-
Gold	3 Kg	-	78	12,844	56,470	13,758
Gold	100 oz	14,749	71,401	97,509	-	-
Plywood	76,032 sq.ft.	144,318	169,550	146,570	261,483	368,770
Western Plywood	76,032 sq.ft.	30,871	-	-	-	-
GNMA Mrtges. CD	$100,000	175	12,619	77,365	6,527	-
GNMA Mrtges. CDR	$100,000	2,292,882	2,325,892	1,371,078	953,161	422,421
Com. Paper (90-day)	$1,000,000	49	15,996	39,702	18,767	3,553
Com. Paper (30-day)	$3,000,000	-	67	1,292	-	-
T-Notes (4-6 year)	$100,000	2,721	450	11,599	-	-
T-Bonds	$100,000	13,907,988	6,489,555	2,059,594	555,350	32,101
Domestic CD (90-day)	$1,000,000	158,920	-	-	-	-
CHICAGO BOARD OF TRADE		49,085,763	45,281,571	33,870,680	27,362,929	23,019,825
Fresh Eggs	22,500 dz	13	2,798	21,224	72,984	130,042
Potatoes	80,000 lb	973	2,481	1,126	90	4,727
Live Hogs	30,000 lb	2,258,083	2,153,767	1,805,710	1,765,201	1,307,712
Pork Bellies, Fzn.	38,000 lb	1,997,697	2,250,945	1,514,176	1,439,651	1,358,730
Live Cattle	40,000 lb	4,282,293	5,997,047	7,214,848	5,592,364	2,639,517
Feeder Cattle	42,000 lb	620,885	874,313	980,619	568,728	133,274
Turkeys	33,000 lb	-	-	-	-	144
Boneless Beef	30,000 lb	-	-	-	-	41
Broilers	30,000 lb	20,048	45,237	7,794	-	-
Lumber	130,000 bd.ft.	635,934	838,676	649,478	560,498	486,691
Stud Lumber	100,000 bd.ft.	156	2,198	5,059	9,365	687
Plywood	152,064 sq.ft.	386	-	-	-	-
Grain Sorghums	400,000 lb	-	-	-	-	-
British Pound	25,000	1,491,102	1,263,750	513,682	240,099	78,701
Canadian Dollar	100,000	475,585	601,925	399,885	207,654	161,139
Deutsche Mark	125,000	1,654,891	922,608	450,856	400,569	134,368
Japanese Yen	12,500,000	960,598	575,073	329,645	361,731	82,261
Mexican Peso	1,000,000	18,905	19,301	29,982	17,844	17,029
Swiss Franc	125,000	1,516,767	827,844	493,944	321,451	106,968
Dutch Guilder	125,000	4	8	22	3,585	2,812
U.S. Silver Coins	$5,000	6	10	59	275	371
French Franc	250,000	2,080	144	406	4,449	3,150
Gold	100 oz	2,516,435	2,543,419	3,558,960	2,812,870	908,180
T-Bills (90-day)	$1,000,000	5,631,290	3,338,773	1,930,482	768,980	321,703
T-Bills (1-year)	$250,000	-	604	11,769	5,564	-
T-Notes (4-6 year)	$250,000	-	338	11,072	-	-
Domestic CD (90-day)	$1,000,000	423,718	-	-	-	-
Eurodollar	$1,000,000	15,171	-	-		-
CHICAGO MERC. EX.		24,527,020	22,261,295	19,930,798	15,153,952	7,878,247
Wheat	5,000 bu	1,181,884	1,297,757	1,037,018	755,949	617,122
Corn	5,000 bu	-	-	-	-	-
Grain Sorghum	5,000 bu	-	290	-	-	15
KANSAS CITY BD. OF TR.		1,181,884	1,298,047	1,037,018	755,949	617,137

	CONTRACT UNIT	1981	1980	1979	1978	1977
Wheat	5,000 bu	357,779	333,610	328,799	284,313	191,098
Durum Wheat	5,000 bu	-	-	-	-	36
Sunflower Seeds	100,000 lb	14,845	27,368	-	-	-
MINNEAPOLIS GRAIN EX.		372,624	360,978	328,799	284,313	191,134
Wheat	1,000 bu	279,082	550,950	379,975	205,629	151,433
Corn	1,000 bu	513,953	440,615	323,808	256,022	280,268
Oats	5,000 bu	4,176	2,364	1,961	1,423	1,172
Soybeans	1,000 bu	849,169	1,052,707	964,596	994,932	1,104,763
Silver	1,000 oz	143,051	209,494	361,576	378,049	366,585
Gold	1 Kg	-	-	4	3,214	2,650
Gold	33.2 oz	469,460	447,494	200,359	41,939	-
Live Cattle	20,000 lb	119,566	186,831	208,997	54,054	-
Live Hogs	15,000 lb	100,139	103,181	127,674	185,927	159,324
T-Bonds	$50,000	109,944	-	-	-	-
MIDAMERICA COM. EX.		2,588,540	2,993,636	2,568,950	2,121,189	2,066,195
Coffee "C"	37,500 lb	515,302	906,944	449,799	163,959	214,202
Sugar #11	112,000 lb	2,470,327	3,576,662	1,792,723	1,016,773	1,055,984
Sugar #12	112,000 lb	14,333	13,839	35,474	21,875	15,676
Cocoa	30,000 lb	-	187,309	231,918	222,732	307,628
Cocoa	10 M tons	562,651	201,662	265	-	-
Rubber	33,000 lb	-	r	-	-	53
COFFEE SUGAR & COCOA		3,562,613	4,886,416	2,510,179	1,425,339	1,593,543
Copper	25,000 lb	1,647,380	1,848,080	2,301,033	1,408,688	1,070,210
Zinc	60,000 lb	3	28	75	677	-
Silver	5,000 oz	1,240,720	1,058,734	4,080,619	3,822,085	3,540,047
Gold	100 oz	10,373,706	8,001,410	6,541,893	3,742,378	981,551
T-Bills (90-day)	$1,000,000	1,052	76,081	27,860	-	-
T-Notes (2-year)	$100,000	30,188	17,653	-	-	-
GNMA Mrtges. CD	$100,000	-	7,403	873	-	-
COMMODITY EXCHANGE		13,293,049	11,009,389	12,952,353	8,973,828	5,591,808
Cotton #2	50,000 lb	1,415,213	2,490,405	1,[illegible]	1,155,801	826,395
Orange Jce,Fzn Con	15,000 lb	387,182	162,864	186,018	285,405	377,921
Propane	100,000 gl	496	25	57	3	301
Petroleum	5,000 brl	-	-	-	-	-
Wool	5,000 lb	-	-	-	-	3
NY COTTON, CIT. & PET.		1,802,891	2,653,294	1,875,126	1,441,209	1,204,620
T-Bills (90-day)	$1,000,000	9,766	32,452	-	-	-
T-Bonds	$100,000	162,942	139,410	-	-	-
Domestic CD (90-day)	$1,000,000	117,807	-	-	-	-
British Pound	25,000	37	7,352	-	-	-
Canadian Dollar	100,000	4	692	-	-	-
Deutsche Mark	125,000	3	258	-	-	-
Japanese Yen	12,500,000	13	199	-	-	-
Swiss Franc	125,000	13	3,630	-	-	-
NY FUTURES EXCHANGE		290,585	183,993	-	-	-

	CONTRACT UNIT	1981	1980	1979	1978	1977
Palladium	100 oz	40,822	62,217	46,994	45,174	19,971
Platinum	50 oz	490,493	429,708	536,124	405,748	122,924
U. S. Silver Coins	$10,000	41	6,808	5,462	9,887	15,514
Gold	1 Kg	-	10	171	620	1,017
Gold	400 oz	-	-	533	2,748	2,633
British Pound	25,000	-	-	420	500	-
Canadian Dollar	100,000	-	-	3,866	181	-
Deutsche Mark	125,000	-	-	182	1,844	-
Japanese Yen	12,500,000	-	-	43	441	-
Swiss Franc	125,000	-	-	45	401	-
Imported Lean Beef	36,000 lb	7,796	24,119	16,704	5,890	2,690
Potatoes, Maine	50,000 lb	-	-	-	-	41,248
Potatoes	50,000 lb	237,411	393,759	183,868	453,215	478,558
No.2 Heating Oil,NY	1,000 brl	995,506	238,284	33,804	116	-
No.2 Heating Oil,Gulf	1,000 brl	1,856	-	-	-	-
Leaded Reg. Gasoline,NY	1,000 brl	7,300	-	-	-	-
No.6 Ind'l Fuel Oil	1,000 brl	-	-	33	28	-
Leaded Reg.Gasoline,Gulf	1,000 brl	2	-	-	-	-
NY MERCANTILE EXCHANGE		1,781,407	1,154,905	828,249	926,793	684,555
Rice, Milled	120,000 lb	10,249	-	-	-	-
Rice, Rough	200,000 lb	11,478	-	-	-	-
Cotton	50,000 lb	9,271	-	-	-	-
Soybeans	5,000 bu	4,997	-	-	-	-
NEW ORLEANS COM. EX.		35,995	-	-	-	-
GNMA Mrtges. CD	$100,000	-	4,530	52,493	16,671	-
T-Bills (90-day)	$1,000,000	-	5	4,334	-	-
T-Bonds	$100,000	-	8,050	7,492	-	-
AMEX COMMODITY EX.		-	12,585	64,319	16,671	-
TOTAL ALL CONTRACTS		98,522,371	92,096,109	75,966,471	58,462,172	42,847,064
CHANGE FROM PREVIOUS YEAR		+7%	+21.2%	+29.9%	+36.3%	+16.3%

VOLUME HIGHLIGHTS

1981 in Comparison with 1980

Rank	Contracts With Volume Over 100,000	1981 Contracts	%	1980 Contracts	%	Rank
1.	T-Bonds, CBT	13,907,988	14.11	6,489,555	7.05	(4)
2.	Corn, CBT	10,674,986	10.83	11,946,975	12.97	(1)
3.	Soybeans, CBT	10,489,932	10.65	11,768,197	12.78	(2)
4.	Gold, COMEX	10,373,706	10.53	8,001,410	8.69	(3)
5.	T-Bills (90-day), CME	5,631,290	5.72	3,338,773	3.63	(8)
6.	Wheat, CBT	4,511,934	4.58	5,428,160	5.89	(6)
7.	Live Cattle, CME	4,282,293	4.35	5,997,047	6.51	(5)
8.	Soybean Oil, CBT	3,047,490	3.09	3,167,895	3.44	(10)
9.	Soybean Meal, CBT	3,039,633	3.09	3,218,690	3.49	(9)
10.	Gold, CME	2,518,435	2.56	2,543,419	2.76	(11)
11.	Sugar #11, CS&C	2,470,327	2.51	3,576,662	3.88	(7)
12.	GNMA Mrtges, CDR, CBT	2,292,882	2.33	2,325,892	2.53	(13)
13.	Live Hogs, CME	2,258,083	2.29	2,153,767	2.34	(15)
14.	Pork Bellies, Fzn, CME	1,997,697	2.03	2,250,945	2.44	(14)
15.	Deutsche Mark, CME	1,654,891	1.68	922,608	1.00	(21)
16.	Copper, COMEX	1,647,380	1.67	1,848,080	2.01	(16)
17.	Swiss Franc, CME	1,518,767	1.54	827,884	.90	(25)
18.	British Pound, CME	1,491,102	1.51	1,263,750	1.37	(18)
19.	Cotton #2, NYCE	1,415,213	1.44	2,490,405	2.70	(12)
20.	Silver(5,000oz)COMEX	1,240,720	1.26	1,058,734	1.15	(19)
21.	Wheat, KCBOT	1,181,884	1.20	1,297,757	1.41	(17)
22.	No.2 Heating Oil,NY,NYME	995,506	1.01	238,284	.26	(37)
23.	Japanese Yen, CME	960,598	.98	575,073	.62	(27)
24.	Soybeans, MIDAM	849,169	.86	1,052,707	1.14	(20)
25.	Lumber, CME	635,934	.65	838,676	.91	(24)
26.	Feeder Cattle, CME	620,885	.63	874,313	.95	(23)
27.	Cocoa, 10M tons, CS&C	562,651	.57	388,971	.42	(33)
28.	Coffee "C", CS&C	515,302	.52	906,944	.98	(22)
29.	Corn, MIDAM	513,953	.52	440,615	.48	(30)
30.	Platinum, NYME	490,493	.50	429,708	.47	(31)
31.	Canadian Dollar, CME	475,585	.48	601,925	.65	(26)
32.	Gold, MIDAM	469,460	.48	447,494	.49	(29)
33.	Domestic CD (90-day), CME	423,718	.43	-	-	
34.	Orange Juice,Fzn Con, NYCE	387,182	.39	162,864	.18	(41)
35.	Oats, CBT	370,103	.38	320,934	.35	(36)
36.	Wheat, MGE	357,779	.36	333,610	.36	(35)
37.	Wheat, MIDAM	279,082	.28	550,950	.60	(28)
38.	Potatoes, NYME	237,411	.24	393,759	.43	(32)
39.	Silver, CBT	214,236	.22	341,033	.37	(34)
40.	Silver, CBT	184,776	.19	-	-	
41.	T-Bonds, NYFE	162,942	.17	139,410	.15	(42)
42.	Domestic CD (90-day), CBT	158,920	.16	-	-	
43.	Plywood, CBT	148,318	.15	169,550	.18	(40)
44.	Silver, MIDAM	143,051	.15	209,494	.23	(38)
45.	Live Cattle, MIDAM	119,566	.12	186,831	.20	(39)
46.	Domestic CD, NYFE	117,807	.12	-	-	
47.	T-Bonds, MIDAM	109,944	.11	-	-	
48.	Live Hogs, MIDAM	100,139	.10	103,181	.11	(43)
	Contracts with Volume Under 100,000 Contracts	275,228	.28	473,178	.52	
	TOTAL	98,522,371	100.00	92,096,109	100.00	

FUTURES INDUSTRY ASSOCIATION
INC.
1919 Pennsylvania Avenue N.W. — Suite 204 • Washington, D.C. 20006 • (202) 466-5460

COMMODITY MARGINS - WHOSE RESPONSIBILITY

by Dr. Mark J. Powers*

Thank you Mr. Stotler, ladies and gentlemen, Chairman Foley. I'm delighted to be with you here today to discuss a most timely topic namely who should have responsibility for the establishment of margins on commodity futures contracts. This topic arises out of the aftermath of the recent episode in silver futures trading. My purpose in discussing this issue with you today is to try to identify some of the issues that have arisen and to put them in the proper perspective.

As I thought about how to present my ideas today I thought the most useful way was to ask myself the questions I would ask if I were in your position as a legislative assistant or as an elected representative who needed to make a decision on these issues.

Let me turn to the questions:

QUESTION 1: HOW DO MARGINS WORK IN THE COMMODITIES MARKET?

When a customer enters into a futures contract either as a buyer or as a seller he must have on deposit with his broker a specified amount of money required by the exchange where the contract is traded. This deposit is called initial or original margin. The money belongs to the customer and is segregated from the funds of the broker. The broker in turn deposits these margins at the exchange clearinghouse. Each day the contracts carried with the exchange clearinghouse are marked-to-the-market and the margins on deposit are adjusted accordingly. This daily marking-to-the-market protects the financial integrity of the entire system permitting the margins on deposit to be kept small in relation to the value of the contracts.

The amount of margins required by the exchange varies from one commodity to another depending upon its price volatility. The exchanges have authority to adjust margins on short notice and raise or lower margins especially when prices are volatile.

---

*Speech presented at Futures Industry Association meeting with Chairman Foley and Congressional staff members.

Exchanges usually require higher initial margins on speculative accounts than on hedging accounts. The reason is that hedge accounts have a smaller financial exposure to price change because by definition the intent of hedging is to use the futures as an offset for risk on cash positions.

Margins are also lower on intramarket spread transactions (long one month short a different month in the same commodity contract). The risk exposure on intramarket spread positions is usually less than that on outright positions.

Maintenance Margins

In addition to setting the minimum level for initial margins the exchange has set a minimum maintenance margin level for each commodity. This is the amount the customer must maintain in his account at all times. Generally it is about 75% of the initial margin. As long as the customers equity (his cash deposit in his account plus or minus his gain or loss in open trades) is not below the maintenance level no further margin level is required. However, if his equity drops below that level he must deposit sufficient funds to bring his margin back to the initial level.

Variation Margin Calls

Calls from the broker to the customer for additional funds to bring the equity back to initial margin levels are called variation margin calls.

Acceptable Margin Deposits

Cash is preferred as initial margin although T-bills may be permitted in particular situations.

Only cash is permitted for variation margin calls. These variation margin calls represent losses on futures positions.

By the same token variation margin credits belong to the customer. Futures trading is a zero sum activity. The daily profits of one trader come from daily losses of other traders and this money is transferred daily to and from the clearinghouse and to and from the individual customer accounts.

QUESTION 2: WHAT IS THE PURPOSE OF COMMODITY MARGINS AND HOW DO COMMODITY MARGINS DIFFER FROM SECURITY MARGINS?

The purpose of commodity margins (the word margin is a misnomer they really should be called security deposits) is to act as a good faith guarantee that the individual who entered into the commodity futures transaction will perform his duties as called for under the terms of the contract. These security deposits are not down payments. Both the buyer and the seller are asked to post these funds. Their purpose is to secure the financial integrity of the transaction.

The purpose of Federal Reserve margin on securities is to prevent excessive use of credit. When someone purchases stock on margin there is an actual transfer of property rights. The seller is paid in full for the stock he has sold to the buyer. If the buyer does not have sufficient funds to pay for the stock in full he borrows the rest through his margin account. Thus, net purchases of stock on margins generate credit and add to the national money supply.

Stock margin requirements have three effects. They limit credit, they limit the volume of purchase on credit, and they limit the individual level of borrowing for purposes of purchasing securities.

The use of margin by the Federal Reserve is a selective instrument in credit controls. It supplements the other powers they have. They can raise margins without tightening other credit. Generally they have raised margins when prices increase and seldom have they had margins below 50%.

In the case of commodity transactions no credit is created and no property rights are transferred. Both parties to a transaction have entered into a promise that at a later date they will transfer property rights to the actual commodity. In the meantime both sides have been asked to post a security deposit at the exchange to affirm the contractual obligations they have undertaken.

QUESTION 3: WHO HAS RESPONSIBILITY NOW FOR COMMODITY MARGINS?

The exchanges have responsibility for establishing commodity margins and for changing them from time to time. Congress has reaffirmed the wisdom of this arrangement a number of times through the years. Each time when the issue has been addressed Congress has determined that it is in the best interest of the public for the exchanges to retain control over the establishment of commodity futures margins.

However, the emergency powers of the CFTC have been construed as giving the CFTC authority to establish margins when the CFTC declares an emergency in the market. They have used that power once in the fall of 1977 when they established a 100% margin on November potatoes.

QUESTION 4: WHAT IS THE OBJECTIVE OF THOSE WHO WOULD REMOVE THE RESPONSIBILITY OF SETTING MARGINS FROM THE EXCHANGES AND TRANSFER THAT POWER TO AN AGENCY OF THE FEDERAL GOVERNMENT?

From all that I have been able to discern in talking to various people interested in this issue and reading newspaper reports it seems that there may be several objectives that various groups believe might be accomplished.

Some feel that placing margin control with a governmental agency would help to control inflation. They believe that low margins cause excessive speculation and that excessive speculation is an engine of inflation. They would use margins to affect the price level. If they thought prices were too high they would adjust margins accordingly. In reality no one knows what constitutes excess speculation. More importantly commodity prices are not the engine of inflation they measure the heat of the engine.

Some feel that the objective would be to reduce price fluctuations in the prices of the various commodities. I know of no evidence that suggests that higher margins actually reduces price fluctuations. Indeed in the short run I rather suspect that higher margins may be closely associated with wider price fluctations as people who are affected by those changes in margin scramble to reduce or eliminate their market positions.

Some feel the objective of changing the responsibility for setting margins is to limit participation in the futures markets. The assumption here is that a government agency would establish margins at a higher level than those established by the exchanges. Certainly experience and common sense suggests that higher margins would reduce the participation in the markets.

Some feel the purpose would be to protect brokerage houses from overextending themselves in carrying customer positions. In my view, if that is a real fear the use of margins to accomplish such an objective is the wrong tool.

When all of the objectives are boiled down they come down to 2 fundamental points. First, that government established margins would be higher than those established by the exchanges and, second, that the fundamental purpose of margins would not be to protect the financial integrity of the price discovery institutions. Rather, they would be used to influence prices or people's desire to do business.

QUESTION 5: IS SUCH A CHANGE IN THE LOCUS OF MARGIN RESPONSIBILITY REALLY IN THE PUBLIC INTEREST?

To answer this question one needs to look at the costs and the benefits of a change from the private establishment of margins to public establishment. Let's turn our attention first to the cost side.

Costs

1. Margins established at higher levels than those necessary to maintain the financial integrity of the futures system will tend to raise the costs of marketing our products. Thus the objective of those that would raise margins in order to help fight inflation would not be met. High margins increase the cost of hedging. There is an interest cost for margin money posted with the broker. The higher the margin the higher this opportunity cost. There is also an execution cost associated with commodity transactions. Execution cost is measured by the spread between the bid and the ask prices and the size of that spread is directly related to the amount of participation in the market. High margins result in reduced participation in the markets, wider spreads and higher hedging costs. These higher hedging costs get passed back to producers in the form of lower prices or forward to consumers in the form of higher prices. The size of these costs is difficult to know, but the direction of the change is not difficult to discern.

A Disruption of the Marketing System

A second major cost that would emanate from a change in the margining system has to do with the tremendous disruption there would be to our marketing and distribution system. The marketing system that has evolved for agricultural products over the last hundred years is a system that closely integrates the price discovery process of the futures market into the pricing in the cash system. If the markets should become less liquid and hedging should become much more expensive it is very likely that many of the institutional arrangements that have evolved over the years will be altered significantly. Many of the forward contracting devices that have been established by local grain elevators and major meat packing firms will be discontinued or made less available to small operators. The cost of marketing agricultural products will increase accordingly. The overall cost to the economy could be enormous.

Although it is difficult to know at this stage precisely what would be the overall impact it is highly likely that the very large firms will benefit most. The smaller firms will find it much more difficult to compete simply because it will be too costly for them to use the futures market as a means of efficiently managing their risk. Many of the forward contracting and forward pricing devices that currently exist in agriculture exist only because the risks associated with those institutional arrangements can be laid off efficiently and at low cost through the commodity futures markets.

Administrative Costs

A third cost that must be considered are the costs associated with administering margins. There are approximately 64 different contracts listed on the exchanges. Most exchanges make a distinction in their margining policy between hedgers and speculators. Further, most exchanges make distinctions between spread transactions and outright positions in the market. When one considers the various combinations and permutations of margins for these different contracts it becomes obvious that there are several hundred different margins that must be established. It is virtually impossible to establish these margins through a pre-established formula.

The establishment of margins is not solely a science. It does require some art. No governmental agency no matter how responsible or how enlightened, and there are some that are both responsible and enlightened, will be sufficiently responsive to the needs of the marketplace to make the decisions on margin frequently enough or fast enough. Further, the data necessary to make correct decisions on margins does not at present reside with any governmental agency. The exchanges are in a much better position, have faster access to the data (on volume, open interest size and ownership of positions, cash market activity, etc.) and a better understanding of the meaning of the data to make responsive and necessary changes in margins.

Benefits

When I turn to the benefit side of this equation I'm hard pressed to find very many benefits that would accrue to the public. At best I believe regulators and elected representatives might get some degree of comfort from knowing that they have control over margins. Such control would be a security blanket for them but a very costly, tattered and torn blanket. It would provide a false sense of security.

Certainly I see no benefit to consumers in providing margin control to a governmental agency. I see no benefit to producers and I see no benefit to the price discovery process. Indeed, I think the price discovery process would be less efficient than it is under the current system.

QUESTION 6: WHO IS BEST EQUIPPED TO HANDLE THE SETTING OF MARGINS AND WHAT IS THEIR RECORD?

In my view exchanges have better and faster access to the correct data and to the expertise for interpreting that data than any governmental agency could ever hope to have. Exchanges have proven, if past history is any guide, that they can and will raise margins when it is necessary to do so in order to protect the financial integrity of the marketplace. The record also suggests that when exchanges have raised margins participation in the marketplace and the total volume of trading did decrease. This is precisely as one should expect and indeed is quite in line with some of the objectives voiced by proponents of giving margin control to the government. But the fundamental objective of the exchanges in raising of margins was not to affect prices or to reduce price fluctuations or to limit participation, it was to protect the financial integrity of the price discovery institutions. The reduced participation was a result not an objective.

The government agencies simply cannot be responsive in a timely fashion. Further, they will be very reluctant to lower margins when it is appropriate.

QUESTION 7: WHAT DID WE LEARN ABOUT MARGIN CONTROL FROM THE RECENT SILVER SITUATION?

It would be naive and foolish of me to stand here and suggest that all was well in the commodity futures industry and that there were no problems in the industry during the recent run-up and subsequent collapse of silver futures prices. Judging from the reports

I've read the industry was very close to some very major problems during the collapse of silver prices. And these problems threatened to spill over into other areas of the financial community. So there can be no denying that potential problems did exist and through fast action and good judgment and most importantly a very resilient and capable futures system a disaster was diverted.

But the question remains. "Would the imposition of higher margins or the control of margins by another agency have made any difference?" In my view the answer is a resounding"no". Margins were raised regularly and to very high levels by the exchanges. Some individual brokerage houses raised margins faster and higher than did the exchanges. The result was that participation in the market dropped but prices continued upward and became more volatile. The market became extremely thin.

The problems that arose and that most people seem to have focused on centred around questions of business judgment - judgments made by particular brokerage houses with respect to the size and extent of the business those houses wished to conduct with particular individuals. In hindsight, it seems relatively easy to point out that several houses over-extended themselves and became too involved with a few customers given the capital of the brokerage house. I see no evidence or suggestion that changing the margining system or raising margins would have had any impact on this aspect of the problem.

It is dangerous and fruitless to believe that we can legislate good business judgment. We cannot. We can however, take a look at business practices within the industry and the rules and regulations of the exchanges governing the capital requirements of its members and the concentration of positions carried by members with a given amount of capital. Focusing attention in this areawill strengthen the entire commodity brokerage industry and in the long run help protect the integrity of the futures system.

QUESTION 8: SHOULD ANY DISTINCTIONS BE MADE BETWEEN MARGIN CONTROL FOR AGRICULTURAL COMMODITIES AND FINANCIAL FUTURES?

The anser is no. The answers given above relate equally to financial futures. The financial futures markets are used for hedging. They do contribute to the information processes and they do help strengthen our capital intermediation service system. Although there are other ways of hedging than through futures, the financial community finds that the futures is a more efficient and less costly means of hedging than through the matching and adjustment of cash positions.

QUESTION 9: WHY NOT GIVE THE FED STANDBY AUTHORITY TO SET MARGINS ON FINANCIAL FUTURES WHEN THEY FEEL IT APPROPRIATE?

As noted above, the CFTC already believes it has that type of emergency power. To also give the authority to the Fed would create added uncertainty as to when, how, and under what criteria the power would be used. Further, standby authority is like being a little bit pregnant. If a government agency has standby authority, someone someday will find an excuse to use it. Given the objectives that many proponents wish to achieve through the margin control, the likelihood is that such authority would be used for some other reason than to maintain the financial integrity of the price discovery institutions. Once the authority is used it will become an additional factor of market uncertainty but not a natural one.

QUESTION 10: SINCE SECURITY OPTIONS ARE MORE SIMILAR TO FUTURES CONTRACTS THAN TO SECURITIES, DO THE ARGUMENTS POSED ABOVE SUGGEST THAT THE FED SHOULD NOT HAVE CONTROL OF THE MARGIN REQUIREMENTS FOR MARGINED SECURITY OPTIONS?

No. A major difference between the trading in security options and futures contracts is that those companies on which options are traded do not have their revenues or costs of doing business affected by the level of margins set by the Fed. Exactly the opposite is the case in futures. As the margins are increased the costs of marketing a bushel of corn or underwriting a bond issue goes up. A delicate balance needs to be kept between providing low cost efficient hedging and price discovery while maintaining the financial integrity of the system.

In summary, I believe the proper place for margin control to rest is with the exchanges. Their past record shows they are responsible and responsive in this area. That is not to suggest that the exchanges do not have an affirmative duty to continue to strive to improve the capital structure of the industry and the system of margining.

STATEMENT OF EDMUND R. SCHROEDER, CHAIRMAN, COMMITTEE ON COMMODITIES REGULATION, AMERICAN BAR ASSOCIATION

March 10, 1982

Good morning, Mr. Chairman. My name is Edmund Schroeder. I am a member of the New York City law firm of Barrett Smith Schapiro Simon & Armstrong. I have been practicing law in the commodities field for over twenty years. From 1976 to 1981, I was the Chairman of the Committee on Commodities Regulation of the Association of the Bar of the City of New York. I am [redacted] the Chairman of the Committee on Commodities Regulation of the Section on Corporation, Banking and Business Law of the American Bar Association.

Our Committee has approximately 320 regular members, who are lawyers practicing in both the private and public sectors, and approximately 50 associates who are economists, exchange administrators, academicians and others involved one way or another in the workings of the commodity markets.

Over the past six months, our Committee has been engaged in a study of possible amendments to the Commodity Exchange Act, with a view to clarifying or otherwise improving provisions which we feel are unclear or inconsistent with other provisions, or which do not adequately or effectively implement Congressional policy. Annexed to my testimony as Exhibit A is a discussion draft containing amendments which the Committee has been considering, together with an explanation of those amendments whose purpose may not be self-evident. The draft reflects suggestions made by many Committee members who contributed to the project. Those suggestions were first developed in subcommittees and were then the subject of extensive discussion by the Committee officers and subcommittee chairmen in a series of meetings held in different cities around the country. A list of the officers and subcommittee chairmen is annexed as Exhibit B to my testimony.

For convenience, I shall refer to the suggested amendments as the Committee Draft. But I want to point out that they are not sponsored or endorsed in any way by the American Bar Association, [redacted] They are [redacted] being presented for your consideration as representing the thinking of many of the leading members of the commodities bar regarding ways in which the Act could be improved.

Many of the proposed amendments are essentially technical and editorial changes which are designed to make the Act easier to read and understand. Among other things, the Committee Draft would create new definitions to replace outdated and repetitive language. For example, a number of provisions in the Act now include a long list of terms (many of which have been out of usage for fifty years) -- "option," "privilege," "indemnity," "bid," "offer," "put," "call," "advance guarantee" and "decline guarantee" -- which refer to essentially the same thing. That list would be replaced by a single, new defined term -- "commodity option." The Committee Draft would also reorganize one section of the Act to place the definitions in numbered subsections, listed in alphabetical order. This should greatly facilitate working with the Act, particularly for those who are unfamiliar with it. The Committee Draft would also amend various sections of the Act to make their terminology consistent with other sections and delete redundant material.

The suggested amendments are presented in Ramsayer form, so that it is easy to see the changes they would make in the existing statute.

I shall now address some of the more significant amendments.

1. Commodity Options. One of the changes proposed in the Committee Draft relates to the commodity option ban now in the Act. In 1978, Congress adopted section 4c of the Act to prohibit sales in the United States of options on commodities that first became regulated in 1975, such as coffee, sugar, cocoa, metals, and financial instruments. This provision was designed to protect the American trading public from abusive practices that had occurred in the sale of such options. However, the language in section 4c has been interpreted by some as barring U.S. traders from making unsolicited purchases of options on foreign markets.

On the theory that the 1978 ban was not intended to deprive U.S. traders of access to a potentially valuable trading vehicle, the Committee Draft would amend section 4c to make it clear that it is not unlawful for a U.S. trader to purchase options abroad. The Draft would not change the existing prohibition against any purchase or sale -- whether or not solicited -- of options involving so-called "enumerated commodities," that is, those agricultural commodities that have been subject to regulation since before 1975.

One other change in the option provisions would be made under the Committee Draft. The present statutory prohibition against option sales contains certain exceptions.

One exception is where the purchaser is a commercial user of the underlying commodity. Under the Committee Draft, Section 4c(c) would be revised to provide that an option seller relying on that exception need only have a "reasonable basis to believe" that the option purchaser is a qualified commercial user of the commodity involved. In this respect, the Committee Draft would make the Act consistent with CFTC regulation 32.4(a).

2. Introducing Brokers. The Committee Draft would create a new category of commodity professional, called an "introducing broker." This would include any person who is engaged in soliciting or accepting orders for domestic futures contracts but who does not accept margins from customers. Under the Committee Draft, introducing brokers would be required to register with the CFTC and would generally be subject to the same regulatory requirements as futures commission merchants. However, they would not be subject to the minimum financial and segregation requirements, since they do not handle customer funds. The introducing broker's sales personnel would also be required to register with the CFTC as "associated persons."

Today, introducing brokers are sometimes referred to as "agents" of futures commission merchants. However, the term "agent" is misleading, since in many cases the futures commission merchant is really the agent of the introducing broker for clearing purposes, or perhaps there is really no agency relationship at all.

In contrast to the Committee Draft, section 9 of S. 2109 (which embodies the CFTC proposals) would require these so-called "agents" and their sales personnel to register with the CFTC as associated persons of a particular futures commission merchant. The result would be to make the futures commission merchant responsible for compliance with various legal and regulatory requirements by the introducing broker and its sales staff.

The problem with the CFTC approach is that introducing brokers are for the most part independent firms and proprietorships scattered throughout the country. In most cases, the futures commission merchants with whom they do business cannot exercise anything like the same control over the introducing brokers as they can over their own employees. The theory of the Committee Draft is that these businesses should stand on their own feet from a regulatory point of view and be directly responsible for meeting their obligations. Of course, if in any case an agency relationship can be shown to exist, then a futures commission merchant could be held liable for the acts or omissions of the introducing broker under traditional agency concepts.1/

3. Commodity Pools. The Committee Draft would also change a number of the regulatory provisions governing commodity pools, which are the commodity industry's counterpart to securities mutual funds.

At the present time, the Act makes "commodity pool operators" subject to registration, record-keeping and various other regulatory requirements. The Committee Draft would address three aspects of this arrangement.

(a) Exclusions. The current statutory definition of "commodity pool operator" is inaccurate and does not reflect the realities of how commodity pools actually

---

1/ See, e.g., Initial Decision in Big Red Commodity Corp. et al., CFTC Docket No. 80-21 (February 23, 1982).

operate. The Committee Draft would add a new term, "commodity pool," which would describe what a pool is. It would also exclude certain entities such as mutual funds, insurance companies, pension plans and entities having fewer than five investors. The reason for that exclusion is that there does not appear to be any compelling reason for these entities to be regulated, inasmuch as they either are already subject to regulation under other statutes or are too small to warrant imposing the regulatory burdens applicable to pools generally.

(b) Registration of Pool Sales Personnel. The Act presently contains no specific CFTC registration or other requirements for the individuals who sell commodity pool interests or who direct trading activities.

The Committee Draft would expand the registration requirements to cover three new classes of people:

1. the sales personnel who solicit pool participants,
2. the individuals who direct the pools' trading activity, and
3. the persons who supervise sales and trading personnel.

All of these individuals would be required to register with the CFTC as "associated persons." As registrants, they would be subject to various other regulatory requirements under the Act.

The Committee Draft is similar in certain respects to the proposal contained in S. 2109. The principal difference is that S. 2109 would only apply to sales personnel and would not require registration of the individuals who direct the pool's trading activity.

The CFTC recently proposed regulations to require registration of commodity pool sales personnel, with an exemption for public offerings covered by the securities laws.[2] Although the Committee Draft would not specifically grant such an exemption, the Committee Draft contains a proposed new Section 8a(10) of the Act (to be discussed later in my testimony) which would give the Commission broad authority to grant exemptions from all statutory requirements where appropriate. The Commission could invoke that authority to exempt public offerings here.

(c) Focus on Pool Entity. The Committee Draft would also change the focus of the commodity pool regulatory requirements. Under the Act as presently drafted, the registration and other regulatory requirements apply to the pool operator, not the pool itself.

The Committee Draft would reverse this approach. The registration, record-keeping and reporting requirements would apply to the pool. This is consistent with the approach used under the securities laws with respect to investment companies (or mutual funds). And it makes sense from a legal and business perspective. For example, the records and reports that are required relate, for the most part, to the pool, and there is no reason why the Act should not apply directly to that entity.

4. Commodity Trading Advisors. The Committee Draft would make two changes in the regulatory requirements governing commodity trading advisors.

To begin with, certain individuals associated with commodity trading advisors would be required to register as associated persons. In general, the registration requirements would apply to personnel involved in soliciting participants, guiding trading or supervising sales and trading personnel. A similar, but somewhat narrower, registration requirement is included in S. 2109. That bill would only require registration of persons engaged in the solicitation of discretionary accounts or the supervision of any person so engaged. Thus, S. 2109 would exclude the persons who actually render trading advice. As a matter of regulatory policy, there does not appear to be any particular reason to distinguish between these individuals and those soliciting for discretionary accounts.

---

[2] Proposed Reg. §1.10g(d)(2), 47 Fed. Reg. 2325 at 2328 (January 15, 1982).

The Committee Draft would also modify the definition of the term "commodity trading advisor." Among other things, it would exclude two groups of individuals: those who are already registered as associated persons, and fiduciaries of pension plans acting under the Employee Retirement Income Security Act of 1974.

5. Registration Procedures. The Committee draft would also amend a number of the provisions in the Act governing registration of commodity industry professionals. At present, these provisions are scattered in different sections and are not entirely consistent with one another.

Under the Committee Draft, all provisions applicable to the registration process would be reorganized and consolidated in a single section. Uniform procedures and standards for denial, suspension or revocation of registration would be established for all registrants. These procedures and standards would be essentially the same as those currently in the Act.

Section 18 of S. 2109 would also consolidate the registration provisions, but it would greatly expand the grounds for denial of registration and would deny the right to a hearing in many cases where a hearing would be required under the present Act. It affords less safeguards for the accused than are present under the corresponding provisions of the securities laws, and it raises a number of issues of fairness and due process which are too detailed to go into here. It should be carefully studied before being enacted in whole or in part.

6. Commission Exemptive Power. The Committee Draft would also add a new section 8a(10), which would give the CFTC authority to grant exemptions from any of the provisions in the Act where appropriate. Other federal agencies, such as the SEC, have similar authority in their governing statutes, and such a provision would give the CFTC needed flexibility in regulating the commodity industry.

* * *

That concludes my testimony. Mr. Chairman, I would be happy to answer any questions you or any other Subcommittee Members may have.

DISCUSSION DRAFT: 3/10/82

EXHIBIT A

POSSIBLE AMENDMENTS TO COMMODITY EXCHANGE ACT

I. Explanation

The draft amendments to the Commodity Exchange Act (the "Act") hereinafter set forth are submitted for discussion and comment to the ABA Committee on Commodities

Regulation by the officers and subcommittee chairmen of the Committee.

1. Definitions. The draft would amend section 2(a)(1) of the Act in several respects:

(a) The definitions in section 2(a) would be divided into separately numbered paragraphs and rearranged in alphabetical order, to facilitate locating and citing the definitions.

(b) The term "commodity pool operator" would be replaced by the term "commodity pool," and the language currently used to define "commodity pool operator" would be amended to reflect the realities of how commodity pools are structured and how they operate. This definition would reflect a change in the statutory scheme whereby the substantive regulatory provisions would apply to the pool, as a separate entity, while the obligations and liabilities of the individuals involved in operating the pool would be established by creating a new category of regulated person, called an "associated person" of a commodity pool. In addition, the scope of the definition would be expanded to cover pools trading all forms of "commodity interests," a newly defined term which would include both domestic and foreign futures contracts, options and leverage transactions. Finally, the term "commodity pool" would exclude certain entities, such as certain mutual funds, insurance companies, pension plans and entities having less than five investors. There appears to be no compelling reason for such entities to be regulated as commodity pools, inasmuch as they are already subject to regulation under other statutes or are too small to warrant imposing the regulatory burdens applicable to pools generally.

(c) The definition of the term "commodity trading advisor" would be changed, among other things, to exclude individuals who are subject to regulation as "associated persons" or "introducing brokers" and to exclude fiduciaries of pension plans acting under ERISA.

(d) A newly defined term, "commodity interest," would be added. This term would include any domestic or foreign futures contract, any commodity option and any leverage transaction. The definition is consistent with Commission Regulation 4.10(a). The term "commodity interest" is substituted for various other terms in many of the substantive provisions of the Act, and careful consideration should be given to whether the substitution is appropriate in each case.

(e) A number of other newly defined terms are created for use in various provisions of the Act for the purpose of eliminating outdated or repetitive language. These terms include "associated person," "commodity option," "contract market," "enumerated commodity," "leverage transaction," "principal" and "regulated commodity transaction." The definitions are for the most part derived from language already in the Act or in Commission Regulations.

2. Commodity Options. In 1978 Congress adopted section 4c of the Act to prohibit sales in the United States of options on the commodities that first became regulated under the Commodity Futures Trading Commission Act of 1974 ("the 1974 Act"), such as cocoa, coffee, sugar, metals, financial futures, etc. Although this provision was designed to protect the American trading public from abusive practices that had occurred in the sales of such options, the language of section 4c has been interpreted by some as depriving U.S. traders from making unsolicited purchases of options on foreign markets. The draft amendment to section 4c would make it clear that it is not unlawful for a U.S. trader to do so. The draft would not change the existing prohibition against any purchase or sale -- whether or not solicited -- of options involving "enumerated commodities," i.e., those subject to regulation before the 1974 Act.

In addition, the draft would amend section 4c(c) to make it clear that a person relying on the so-called trade option exemption need only have a "reasonable basis to believe" that the option purchaser is a qualified commercial user of the commodity involved. In this respect the draft would make the Act consistent with Commission Regulation 32.4(a).

3. Introducing Brokers. A new category of commodity professional would be created, called an "introducing broker." This would include any person who is engaged in soliciting or accepting orders for domestic futures contracts but who does not accept margins from customers. In the past,

these persons have commonly been referred to as "agents" of futures commission merchants. The term "agent" is not used in the draft, primarily because in many cases the term does not correctly reflect the legal relationship between the broker and futures commission merchant. Introducing brokers would generally be subject to the same regulatory requirements as futures commission merchants, except for the financial and segregation requirements, since they do not handle customer funds.

4. Commodity Pools. The draft proposal would amend sections 4k, 4l, 4m, 4n and 4o in several respects. As noted above, it would establish different regulatory requirements for a commodity pool, as a separate entity, and for the persons operating the pool. In general, the pool itself would be subject to the same regulatory requirements now applied to pool operators.

Section 4k would be amended to provide for registration of persons involved in soliciting pool participants, guiding trading for the pool, or supervising sales and trading personnel. As registrants, these individuals would be subject to reparations proceedings and other provisions of the Act. Principals of a pool would not necessarily be required to register with the Commission.

Sections 4m and 4n would be amended to provide for registration of a commodity pool itself (instead of its operator) and to provide for the pool to keep the records and furnish the account statements now required of pool operators. A number of other changes would be made in section 4n, including the following:

(a) The provisions in section 4n(1) concerning the information required in an application for registration would be deleted as unnecessary because the Commission can by regulation prescribe the information it needs.[1]

(b) Section 4n(3) would be amended by deleting the phrases "registered under this Act" and "registered" because there does not appear to be any reason to have compliance with the recordkeeping requirements depend (as a statutory matter) upon whether a pool is registered. The requirement in section 4n(3)(B) that principals disclose their positions to clients or participants would also be deleted. This is consistent with Commission Regulation 4.11. If the Commission desires, at some future time, to require such disclosures, it would have that authority under the proposed amendments of section 4n(3).

(c) Sections 4n(5) and 4n(6) would be deleted. All provisions governing the granting, suspending and revoking of the registration of all commodity professionals would be reorganized and consolidated in sections 8a(2) and (3).

Section 4o would be amended so that the antifraud provisions would apply to any commodity trading advisor, any commodity pool, and any principal or associated person of a commodity trading advisor or commodity pool. The phrase "registered under this Act" would be deleted for the reasons discussed above in connection with section 4n(3).

The legislative findings currently in section 41 would be eliminated, because they are unnecessary and inconsistent with the policy of extending commodity pool and commodity trading advisor regulation to commodity trading beyond merely that conducted on U.S. contract markets. Existing section 41 would be replaced by an anti-manipulation provision discussed below.

5. Registration. The draft would amend sections 4f, 4k, 4m, 4n and 8a to reorganize and clarify

---

[1] A similar change would be made in section 4f(1) regarding applications for registration by futures commission merchants, introducing brokers and floor brokers.

the provisions governing registration of commodity industry professionals. The draft would also require that several new groups of commodity professionals register with the Commission. The principal changes may be summarized as follows:

> (a) As noted above, introducing brokers and their sales personnel would be required to register under proposed amendments of sections 4f(1) and 4k(1).
>
> (b) Certain individuals associated with commodity pools and commodity trading advisors would be required to register under proposed new sections 4k(2) and (3). In general, the registration requirement would apply to personnel involved in soliciting participants, guiding trading or supervising sales and trading personnel.
>
> (c) The registration procedures in sections 4n and 8a would be substantially revised to establish uniform procedures and standards for denial of registration for all types of registrants. The new provisions would be in sections 8a(2) and (3).

6. Recordkeeping. The draft would amend sections 4g and 5(b) to clarify and reorganize the recordkeeping and reporting requirements and to make the terminology in those sections conform more closely with that used in other sections of the Act. For example, references to "exchanges" would be changed to "contract markets." And "clearinghouse" would be changed to "clearing organization." The draft would also delete apparently redundant material in section 5(b) describing the records contract markets must keep concerning cash and futures transactions of members.

7. Commission Exemptive Power. The draft would add a new section 8a(10) to give the Commission authority to grant exemptions from provisions in the Act or Commission regulations.

8. Exchange Disciplinary Proceedings. The draft would amend section 8c by changing the word "exchange" to "contract market" wherever it appears.

This is essentially a technical change which, together with a similar change in section 4g, is designed to make the terminology in the Act more uniform.

9. Manipulation. The draft would add a new section 41 to make it "unlawful" to manipulate commodity prices or to corner commodities. New section 41 would be added to make it clear that the Commission may seek to enjoin any manipulation or corner. The draft is not intended to reflect any view, one way or the other, as to whether there should be an implied federal civil remedy for damages under the anti-manipulation provisions in the Act.

10. Other Amendments. The draft would amend several other sections of the Act. Most of these proposed amendments are technical and editorial changes, as shown in the annexed Ramsayer. For example, the proposal would delete apparently obsolete provisions in sections 2(a)(2)(A), 2(a)(7)(B)(ii), 4c(b) and 4j of the Act. The draft would also clarify certain obligations of contract markets under section 5 of the Act.

II. Text of Amendments

(Listed below are provisions of the Commodity Exchange Act marked to show possible amendments. Deletions are placed in brackets; additions are underscored.)

Sec. 2. (a)(1) For the purposes of this Act:

(i) "associated person" shall mean any person required to register under section 4k of this Act.

(ii) [~~The words~~] "board of trade" shall [~~be held to include and~~] mean any exchange or association, whether incorporated or unincorporated, of persons who shall be engaged in the business of buying or selling any commodity or receiving the same for sale on consignment.

(iii) [~~The words~~] "the Commission" shall mean the Commodity Futures Trading Commission established under paragraph (2) of this section. The Commission shall have exclusive jurisdiction with respect to accounts, agreements (including any commodity option [~~transaction which is of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty"~~]), and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market designated pursuant to section 5 of this Act or any other board of trade, exchange, or market, and transactions subject to regulation by the Commission pursuant to section 19 of this Act: [~~And~~] Provided [~~further~~], That, except as hereinabove provided, nothing contained in this section shall (i) supersede or limit the jurisdiction at any time conferred on the Securities and Exchange Commission or other regulatory authorities under the laws of the United States or of any State, or (ii) restrict the Securities and Exchange Commission and such other authorities from carrying out their duties and resposibilities in accordance with such laws. Nothing in this section shall supersede or limit the jurisdiction conferred on courts of the United States or any State. Nothing in this Act shall be deemed to govern or in any way be applicable to transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade.

(iv) [~~The word~~] "commodity" shall mean any enumerated commodity [~~wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice~~] and all other goods and articles, except onions as provided in Public Law 85-839, and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in [~~: Provided, That~~].

(v) "commodity interest" shall mean any contract for the purchase or sale of a commodity for future delivery traded or executed on a contract market or any other board of trade, exchange or market, any commodity option and any leverage transaction.

(vi) "commodity option" shall mean any contractual right to buy or to sell a commodity or a contract of sale of a commodity for future delivery at an agreed price during an agreed period without the obligation to do so and, in addition, any transaction which is of the character of, or is commonly known to the trade as, a "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty".

(vii) "commodity pool" [~~operator~~] shall mean any [~~person engaged in a~~] form of business which is in the nature of the discretionary trading of pooled assets, an investment trust, syndicate, or similar form of enterprise which [~~and who in connection therewith~~] solicits, accepts or receives from others, monies, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in any commodity interests, but does not include (i) any group of persons less than 5 in number, (ii) any person regulated under the Investment Company Act of 1940 or any insurance company or any common trust program of a bank or trust company, in each case which utilizes less than 5% of its assets (as margins or premiums) in trading commodity interests and which was not marketed to the public as a commodity pool, (iii) any employee benefit plan subject to the provisions of the Employee Retirement Income Security Act of 1974 or any trustee or fiduciary thereof, or (iv) such other persons not within the intent of this definition as the Commission may specify by rule, regulation or order: Provided, That those entities which are excluded from the definition of a commodity pool by virtue of clauses (ii) and (iii) above shall not, by virtue of such exclusion, be excluded or exempted from any other provisions of this Act which are otherwise applicable to them.

(viii) [~~The term~~] "commodity trading advisor" shall mean any person who, for compensation or profit, engages in the business of advising others, either directly or through publications or writings, as to the value of commodities or commodity interests or as to the advisability of trading in any commodity interests [~~commodity for future delivery on or subject to the rules of any contract market~~], or who for compensation or profit, and as part of a regular business, issues or promulgates analyses or reports concerning commodities or commodity interests; but does not include (i) any bank or trust company, (ii) any newspaper reporter, newspaper columnist, newspaper editor, lawyer, accountant, or teacher, (iii) any floor broker, [~~or~~] futures commission merchant, introducing broker or associated person, (iv) the publisher of any bona fide newspaper, news magazine, or business or financial publication of general and regular circulation including their employees, (v) any contract market, (vi) any fiduciary acting under the provisions of the Employee Retirement Income Security Act of 1974, and (vii) such other persons not within the intent of this definition as the Commission may specify by rule, regulation, or order: Provided, That the furnishing of such services by the foregoing persons is solely incidental to the conduct of their business or profession.

(ix) "contract market" shall mean any board of trade or exchange that is designated as a contract market by the Commission.

(x) "contract of sale" shall [be held to] include sales, agreements of sale, and agreements to sell.

(xi) [~~The words~~] "cooperative association of producers" shall mean any cooperative association, corporate or otherwise, not less than 75 per centum in good faith owned or controlled, directly or indirectly, by producers of agricultural products and otherwise complying with an Act of Congress of February 18, 1922 (U.S.C., 1934 ed., title 7, secs. 291 and 292), as now or hereafter amended, including any organization acting for a group of such associations and owned or controlled by such associations, provided that business done for or with the United States of America, or any agency thereof, shall not be considered either member or nonmember business in determining the compliance of any such association with said Act of Congress of February 18, 1922.

(xii) "enumerated commodity" shall mean wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice.

(xiii) [~~The words~~] "floor broker" shall mean any person who, in or surrounding any "pit", "ring", "post", or other place provided by a contract market for the meeting of persons similarly engaged, shall purchase or sell for any other person any commodity for future delivery on or subject to the rules of any contract market.

(xiv) [~~The words~~] "futures commission merchant" shall mean [~~and include individuals, associations, partnerships, corporations, and trusts~~] any person engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market and [~~that~~], in or in connection with such solicitation or acceptance of orders, accepts any money, securities, or property (or extends credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom.

(xv) [~~The term~~] "future delivery" [~~, as used herein,~~] shall not include any sale of a cash commodity for deferred shipment or delivery.

(xvi) [~~The words~~] "interstate commerce" shall [~~be construed to~~] mean commerce between any State, Territory, or possession, or the District of Columbia, and any place outside thereof; or between points within the same State, Territory, or possession, or the District of Columbia, but through any place outside thereof, or within any Territory or possession, or the District of Columbia, and (without limiting the generality of the foregoing) a transaction in respect to any article shall be considered to be in interstate commerce if such article is part of that current of commerce usual in the commodity trade whereby commodities and commodity products and byproducts thereof are sent from one State with the expectation that they will end their transit, after purchase, in another, including, in addition to cases within the above general description, all cases where purchase or sale is either for shipment to another State, or for manufacture within the State and the shipment outside the State of the products resulting from such manufacture. Articles normally in such current of commerce shall not be considered out of such commerce through resort being had to any means or device intended to remove transactions in respect thereto from the provisions of this Act. For the purpose of this paragraph the word "State" includes Territory, the District of Columbia, possession of the United States, and foreign nations.

(xvii) "introducing broker" means any person engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market who does not accept any money, securities, or property (or extend credit in lieu thereof) to margin, guarantee, or secure any trades or contracts that result or may result therefrom.

(xviii) "leverage transaction" shall mean a transaction pursuant to a standardized contract commonly known to the trade as a margin account, margin contract, leverage account, or leverage contract, or any contract, account, arrangement, scheme, or device that the Commission determines serves the same function or functions as such a standardized contract, or is marketed or managed in substantially the same manner as such a standardized contract.

(xix) [~~The words~~] "member of a contract market" shall mean [~~and include individuals, associations, partnerships, corporations, and trusts~~] any person owning or holding membership in, or admitted to membership representation on, a contract market or given members' trading privileges thereon.

(xx) [~~The word~~] "person" shall [~~be construed to import~~] include the plural or singular, and shall include individuals, associations, partnerships, corporations, and trusts.

(xxi) "principal" shall mean, with respect to any juridical entity, a general partner, officer or director of the entity and any person exercising the functions thereof with respect to the entity, or any person exercising control of the entity.

(xxii) "regulated commodity transaction" shall mean any contract, purchase, sale, trade, order or other form of trading activity involving any commodity, which is or may be used for (i) hedging any transaction in interstate commerce in such commodity, or the products or byproducts thereof, or (ii) determining the price basis of any such transaction in interstate commerce in such commodity, or (iii) delivering any such commodity sold, shipped, or received in interstate commerce for the fulfillment thereof.

(xxiii) The act, omission, or failure of any official, agent, or other person acting for any individual, association, partnership, corporation, or trust within the scope of his employment or office shall be deemed the act, omission, or failure of such individual, association, partnership, corporation, or trust, as well as of such official, agent, or other person.

(2)(A) There is hereby established, as an independent agency of the United States Government, a Commodity Futures Trading Commission. The Commission shall be composed of five Commissioners, who shall be appointed by the President, by and with the advice and consent of the Senate. In nominating persons for appointment, the President shall seek to establish and maintain a balanced Commission, including, but not limited to, persons of demonstrated knowledge in futures trading or its regulation and persons of demonstrated knowledge in the production, merchandising, processing or distribution of one or more of the commodities or other goods and articles, services, rights and interests covered by this Act. Not more than three of the members of the Commission shall be members of the same political party. Each Commissioner shall hold office for a term of five years and until his successor is appointed and has qualified, except that he shall not so continue to serve beyond the expiration of the next session of Congress subsequent to the expiration of said fixed term of office, and except [~~(i)~~] any Commissioner appointed to fill a vacancy occurring prior to the expiration of the term for which his predecessor was appointed shall be appointed for the remainder of such term [~~, and (ii) the terms of office of the Commissioners first taking office after the enactment of this paragraph shall expire as designated by the President at the time of nomination, one at the end of one year, one at the end of four years, and one at the end of five years~~].

* * * *

(7)(A) No Commissioner or employee of the Commission shall accept employment or compensation from any person [~~, exchange, or clearinghouse~~] subject to regulation by the Commission under this Act during his term of office, nor shall he participate, directly or indirectly, in any [~~contract market~~] business operations of a person subject to regulation by the Commission or in any transactions of a character subject to regulation by the Commission.

(B) No Commissioner or employee of the Commission classified as a GS-16 or higher in a position excepted from the competitive service by reason of being of a confidential or policymaking character shall, for a period of one year beginning on the last day of service as such Commissioner or employee—

(i) make any appearance before the Commission, or

(ii) make any written or oral communication to the Commission, or any Commissioner or employee of the Commission, on behalf of any person (other than the United States) on any particular matter that is before the Commission[~~,~~]. [~~if such last day of service is more than four months after the date of enactment of this subparagraph.~~] The restrictions in this subparagraph shall not apply to an appearance or response under a subpena issued by the Commission, or any matter of an exclusively personal and individual nature.

* * * *

[~~(b) For the purposes of this Act (but not in any wise limiting the foregoing definition of interstate commerce) a transaction in respect to any article shall be considered to be in interstate commerce if such article is part of that current of commerce usual in the commodity trade whereby commodities and commodity product and byproducts thereof are sent from one State with the expectation that they will end their transit, after purchase, in another, including, in addition to cases within the above general description, all cases where purchase or sale is either for shipment to another State, or for manufacture within the State and the shipment outside the State of the products resulting from such manufacture. Articles normally in such current of commerce shall not be considered out of such commerce through resort being had to any means or device intended to remove transactions in respect thereto from the provisions of this Act. For the purpose of this paragraph the word "State" includes Territory, the District of Columbia, possession of the United States, and foreign nation.~~]

* * * *

Sec. 4. It shall be unlawful for any person to deliver for transmission through the mails or in interstate commerce by telegraph, telephone, wireless, or other means of communication any offer to make or execute, or any confirmation of the execution of, or any quotation or report of the price of, any contract of sale of commodities for future delivery on or subject to the rules of any board of trade in the United States, or for any person to make or execute such contract of sale, which is a regulated commodity transaction [~~or may be used for (a) hedging any transaction in interstate commerce in commodities or the products or by-products thereof, or (b) determining the price basis of any such transaction in interstate commerce~~

~~for the fulfillment thereof~~], except, in any of the foregoing cases, where such contract is made by or through a member of a board of trade which has been designated by the Commission as a "contract market," as hereinafter provided, and if such contract is evidenced by a record in writing which shows the date, the parties to such contract and their addresses, the property covered and its price, and the terms of delivery: Provided, That each board member shall keep such record for a period of three years from the date thereof, or for a longer period if the Commission shall so direct, which record shall at all times be open to the inspection of any representative of the Commission or the United States Department of Justice.

* * * *

(3) No order issued under paragraph (1) of this section shall apply to transactions or positions which are shown to be bona fide hedging transactions or positions as such terms shall be defined by the Commission [~~within ninety days after the effective date of the Commodity Futures Trading Commission Act of 1974~~] by order consistent with the purposes of this Act.

(4) This section shall apply to a person that is registered as a futures commission merchant, introducing broker or [~~or~~] floor broker under authority of this Act only to the extent that transactions made by such person are made on behalf of or for the account or benefit of such person. This section shall not apply to transactions made by, or on behalf of, or at the direction of, the United States, or a duly authorized agency thereof.

Sec. 4b. It shall be unlawful (1) for any member of a contract market, or for any correspondent, agent, or employee of any member, in or in connection with any order to make, or the making of, any contract of sale of any commodity in interstate commerce, made, or to be made, on or subject to the rules of any contract market, for or on behalf of any other person, or (2) for any person, in or in connection with any order to make, or the making of, any contract of sale of any commodity for future delivery, made, or to be made, on or subject to the rules of any contract market, for or on behalf of any other person if such contract for future delivery is a regulated commodity transaction [~~or may be used for (a) hedging any transaction in interstate commerce in such commodity or the products or byproducts thereof, or (b) determining the price basis of any transaction in interstate commerce in such commodity, or (c) delivering any such commodity sold, shipped, or received in interstate commerce for the fulfillment thereof~~]—

(A) to cheat or defraud or attempt to cheat or defraud such other person;

(B) willfully to make or cause to be made to such other person any false report or statement thereof, or willfully to enter or cause to be entered for such person any false record thereof;

(C) willfully to deceive or attempt to deceive such other person by any means whatsoever in regard to any such order or contract or the disposition or execution of any such order or contract, or in regard to any act of agency performed with respect to such order or contract for such person; and

(D) to bucket such order, or to fill such order by offset against the order or orders of any other person, or willfully and knowingly and without the prior consent of such person to become the buyer in respect to any selling order of such person, or become the seller in respect to any buying order of such person. . . .

* * * *

Sec. 4c. (a) It shall be unlawful for any person to offer to enter into, enter into, or confirm the execution of, any regulated commodity transaction [~~involving any commodity, which is or may be used for (1) hedging any transaction in interstate commerce in such commodity or the products or byproducts thereof, or (2) determining the price basis of any such transaction in interstate commerce in such commodity, or (3) delivering any such commodity sold, shipped, or received in interstate commerce for the fulfillment thereof~~]—

(A) if such transaction is, is of the character of, or is commonly known to the trade as, a "wash sale", "cross trade", or "accommodation trade", or is a fictitious sale;

(B) if such transaction includes a commodity option involving an enumerated commodity [~~involves any commodity specifically set forth in section 2(a) of this Act, prior to the enactment of the Commodity Futures Trading Commission Act of 1974, and if such transaction is of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty"~~]; or

(C) if such transaction is used to cause any price to be reported, registered, or recorded which is not a true and bona fide price. . . .

* * * *

(b) No person shall sell, offer to sell, or solicit an offer to buy a commodity option involving a commodity other than an enumerated commodity [~~enter into, enter into, or confirm the execution of, any transaction subject to the provisions of subsection (a) of this section involving any commodity regulated under this Act, but not specifically set forth in section 2(a) of this Act, prior to the enactment of the Commodity Futures Trading Commission Act of 1974, which is of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty"~~], contrary to any rule, regulation, or order of the Commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe [~~within one year after the effective date of the Commodity Futures Trading Commission Act of 1974 unless the Commission determines and notifies the Senate Committee on Agriculture, Nutrition, and Forestry and the House Committee on Agriculture that it is unable to prescribe such terms and conditions within such period of time~~]: Provided, That any such order, rule, or regulation may be made only after notice and opportunity for hearing: And provided further, That the Commission may set different terms and conditions for different markets.

(c) Notwithstanding the provisions of subsection (b) of this section, no person may, after the enactment of the Futures Trading Act of 1978, sell, offer to sell, or solicit an offer to buy a commodity option involving a commodity other than an enumerated commodity [~~enter into, enter into, or confirm the execution of any commodity option transaction involving any commodity regulated under this Act but not specifically set forth in section 2(a) of this Act prior to the enactment of the Commodity Futures Trading Commission Act of 1974~~], until (1) the Commission transmits to the House Committee on Agriculture and the Senate Committee on Agriculture, Nutrition, and Forestry, documentation of its ability to regulate successfully such transactions, including a copy of the Commission's proposed rules and regulations, and (2) the expiration of thirty calendar days of continuous session of Congress after the date of such transmittal. The Commission is not precluded from transmitting, at any time, documentation relating to its ability to regulate such transactions regarding individual commodities, classes of commodities, or regulation of such transactions on specific boards of trade. Nothing in this subsection shall affect any rights or obligations arising out of any transactions subject to the provisions of this subsection entered into, or the execution of which was confirmed, prior to October 1, 1978: Provided, That this prohibition shall not apply to any transaction expressly permitted under rules or regulations prescribed by the Commission, before or after the date of enactment of the Futures Trading Act of 1978, to be offered to be entered into, entered into, or confirmed in which the person selling such commodity option has a reasonable basis to believe that the purchaser is a producer, processor, commercial user of, or a merchant handling, the commodity involved in the transaction or the products or byproducts thereof.

(d) Notwithstanding the provisions of subsection (c) of this section—

(1) any person domiciled in the United States who on May 1, 1978, was in the business of granting [~~an~~] a commodity option on a physical commodity and was in the business of buying, selling, producing, or otherwise using that commodity, may continue to grant or issue options on that commodity in accordance with Commission regulations in effect on August 17, 1978, until thirty days after the effective date of regulations issued by the Commission under clause (2) of this subsection: Provided, That if such

person files an application for registration under the regulations issued under clause (2) of this subsection within thirty days after the effective date of such regulations, that person may continue to grant or issue options pending a final determination by the Commission on the application; and (2) the Commission shall issue regulations that permit grantors and futures commission merchants to sell, [~~to~~] offer to sell, or solicit any offer to buy [~~enter into, enter into, or confirm the execution of~~], any commodity option [~~transaction~~] on a physical commodity subject to the provisions of subsection (b) of this section if—

(A) the grantor is a person domiciled in the United States who—

(i) is in the business of buying, selling, producing, or otherwise using the underlying commodity;

* * * *

The Commission may permit persons not domiciled in the United States to grant commodity options under this subsection under such additional rules, regulations, and orders as the Commission may adopt to provide protection to purchasers that are substantially the equivalent of those applicable to grantors domiciled in the United States. The Commission may terminate the right of any person to grant, offer, or sell commodity options under this subsection only after a hearing, including a finding that the continuation of such right is contrary to the public interest: Provided, That pending the completion of such termination proceedings, the Commission may suspend the right to grant, offer, or sell options of any person whose activities in the Commission's judgment present a substantial risk to the public interest.

(e) The Commission may adopt rules and regulations, after public notice and opportunity for a hearing on the record, prohibiting the granting, issuance, or sale of commodity options permitted under subsection (d) of this section if the Commission determines that such options are contrary to the public interest.

Sec. 4d. It shall be unlawful for any person to engage as futures commission merchant or introducing broker in soliciting orders or accepting orders for the purchase or sale of any commodity for future delivery, or involving any contracts of sale of any commodity for future delivery, on or subject to the rules of any contract market unless—

(1) such person shall have registered, under this Act, with the Commission as such futures commission merchant or introducing broker and such registration shall not have expired nor been suspended nor revoked; and

(2) such person shall, if a futures commission merchant, whether a member or nonmember of a contract market, treat and deal with all money, securities, and property received by such person to margin, guarantee, or secure the trades or contracts of any customer of such person, or accruing to such customer as the result of such trades or contracts, as belonging to such customer. Such money, securities, and property shall be separately accounted for and shall not be commingled with the funds of such commission merchant or be used to margin or guarantee the trades or contracts, or to secure or extend the credit, of any customer or person other than the one for whom the same are held: Provided, however, That such money, securities, and property of the customers of such futures commission merchant may, for convenience, be commingled and deposited in the same account or accounts with any bank or trust company or with the clearinghouse organization of such contract market, and that such share thereof as in the normal course of business shall be necessary to margin, guarantee, secure, transfer, adjust, or settle the contracts or trades of such customers, or resulting market positions, with the clearinghouse organization of such contract market or with any member of such contract market, may be withdrawn and applied to such purposes, including the payment of commissions, brokerage, interest, taxes, storage, and other charges, lawfully accruing in connection with such contracts and trades: Provided further, That in accordance with such terms and conditions as the Commission may prescribe by rule, regulation, or order, such money, securities, and property of the customers of such futures commission merchant may be commingled and deposited as provided in this section with any other money, securities, and property received by such futures commission merchant and required by the Commission to be separately accounted for and treated and dealt with as belonging to the customers of

such futures commission merchant: Provided further, That such money may be invested in obligations of the United States, in general obligations of any State or of any political subdivision thereof, and in obligations fully guaranteed as to principal and interest by the United States, such investments to be made in accordance with such rules and regulations and subject to such conditions as the Commission may prescribe. . . .

* * * *

Sec. 4f. (1) Any person desiring to register as futures commission merchant, introducing broker or [~~as~~] floor broker hereunder shall be registered upon application to the Commission, which application shall be made in form and manner to be prescribed by the Commission, giving such information and facts as the Commission may deem necessary or appropriate in order to determine whether the applicant is qualified for registration. [~~concerning the business in which the applicant is or will be engaged including, in the case of applications of futures commission merchants, the names and addresses of the managers of all branch offices and of all correspondents and agents engaged in soliciting or accepting on behalf of such applicant any orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any board of trade, and including also the names of its officers and partners, if a partnership, and of its officers, directors, and stockholders, as the Commission may require.~~] Such person, when registered hereunder, shall likewise continue to report and furnish to the Commission such information as the Commission may require. Each registration shall expire on December 31 of the year for which issued or at such other time, not less than one year from the date of issuance, as the Commission may by rule, regulation, or order prescribe, and shall be renewed upon application therefor unless the registration has been suspended (and the period of such suspension has not expired) or revoked after notice and hearing as prescribed in this Act.

(2) Notwithstanding any other provisions of this Act, no person desiring to register as futures commission merchant shall be so registered unless he meets such minimum financial requirements as the Commission may by regulation prescribe as necessary to insure his meeting his obligations as a registrant, and each person so registered shall at all times continue to meet such prescribed minimum financial requirements: Provided, That such minimum financial requirements will be considered met if the applicant for registration or registrant is a member of a contract market and conforms to minimum financial standards and related reporting requirements set by such contract market in its bylaws, rules, regulations, or resolutions and approved by the Commission as adequate to effectuate the purposes of this paragraph (2).

Sec. 4g. (1) Every [~~person registered hereunder as~~] futures commission merchant, introducing broker or floor broker shall make such reports as are required by the Commission regarding the transactions and positions of such person, and the transactions and positions of the customers thereof, in contracts of sale of any commodity for future delivery traded or executed on or subject to the rules of [~~commodities for future delivery on~~] any board of trade in the United States or elsewhere; shall keep books and records pertaining to such transactions and positions in such form and manner and for such period as [~~may be required by~~] the Commission by rule may require and shall keep such books and records open to inspection by any representative of the Commission or the United States Department of Justice.

(2) Every [~~clearinghouse and~~] contract market and clearing organization shall maintain daily trading records. Floor brokers and futures commission merchants shall maintain daily trading records for each customer in such manner and form as to be identifiable with the trades represented in the trading records maintained by such contract markets and clearing organizations. The daily trading records shall include such information, shall be maintained in such form and shall be retained for such time as the Commission shall prescribe by rule.

[~~(3) Floor brokers and futures commission merchants shall maintain daily trading records for each customer in such manner and form as to be identifiable with the trades referred to in subsection (2).~~

~~(4) Daily trading records shall be maintained in a form suitable to the Commission for such period as may be required by the Commission.~~]

(3) Reports shall be made from the records maintained at such times and at such places and in such form as the Commission may prescribe by rule,

order, or regulation in order to protect the public interest and the interest of persons trading in commodity [~~futures~~] interests.

[~~(5)~~] (4) Before the beginning of trading each day, [~~the exchange~~] each contract market shall, insofar as is practicable and under terms and conditions specified by the Commission, make public the volume of trading on each type of contract for the previous day and such other information as the Commission deems necessary in the public interest and prescribes by rule, order or regulation.

[~~(6)~~] (5) Nothing contained in this section shall be construed to prohibit the Commission from establishing [~~making~~] separate [~~determinations~~] reporting and record keeping requirements for different [~~clearinghouses,~~] contract markets[~~,~~] and [~~exchanges when such determinations are warranted in the judgment of the Commission~~] clearing organizations.

Sec. 4h. It shall be unlawful for any person—

(1) to conduct any office or place of business anywhere in the United States or its territories for the purpose of soliciting or accepting any orders for the purchase or sale of any commodity for future delivery, or for making or offering to make any contracts for the purchase or sale of any commodity for future delivery, or for conducting any dealings in commodities for future delivery, that are regulated commodity transactions [~~or may be used for~~

~~(A) hedging any transaction in interstate commerce in such commodity or the products or byproducts thereof, or~~

~~(B) determining the price basis of any such transaction in interstate commerce, or~~

~~(C) delivering any such commodity sold, shipped, or received in interstate commerce for the fulfillment thereof~~],

if such orders, contracts, or dealings are executed or consummated otherwise than by or through a member of a contract market; or

* * * *

Sec. 4i. It shall be unlawful for any person to make any contract for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market unless such person shall report or cause to be reported to the properly designated officer in accordance with the rules and regulations of the Commission (1) whenever such person shall directly or indirectly make such contracts with respect to any commodity, or any future of such commodity, during any one day in an amount equal to or in excess of such amount as shall be fixed from time to time by the Commission; and (2) whenever such person shall directly or indirectly have or obtain a long or short position in any commodity or in any future of such commodity, equal to or in excess of such amount as shall be fixed from time to time by the Commission. Such person shall keep books and records of all futures transactions and positions coming within the provisions of (1) and (2) hereof, and shall keep books and records of such cash or spot transactions in such commodity entered into, and inventories and purchase and sale commitments of such commodity held, in any month in which such person is required to make any report under the provisions of (1) or (2), as the Commission may require. Such books and records [~~shall show complete details concerning all such transactions, positions, inventories, and commitments, including the names and addresses of all persons having any interest therein, and~~] shall be open at all times to inspection by any representative of the Commission or the United States Department of Justice. For the purposes of this section, the futures and cash or spot transactions and positions of any person shall include such transactions and positions [~~of any persons~~] directly or indirectly controlled by such person.

Sec. 4j. (1) The Commission shall determine, [~~within six months after the effective date of the Commodity Futures Trading Commission Act of 1974, and subsequently when it determines that changes are required, make a determination,~~] after notice and opportunity for hearing, whether or not a floor broker may trade for his own account or any account in which such broker has trading discretion, and also execute a customer's order for a commodity interest ~~[future delivery]~~ and, if the Commission determines that such trades and such executions shall be permitted, the Commission shall further determine the terms, conditions, and circumstances under which such trades and such executions shall be conducted: Provided, That any such determination shall, at a minimum, take into account the effect upon the liquidity of trading of each market: And provided further, That nothing herein shall be construed to prohibit the Commission from making separate determinations for different contract markets when such are warranted in the judgment of the Commission, or to prohibit contract markets from setting terms and conditions more restrictive than those set by the Commission.

(2) The Commission shall determine, ~~[within six months after the effective date of the Commodity Futures Trading Commission Act of 1974, and subsequently when it determines that changes are required, make a determination,]~~ after notice and opportunity for hearing, whether or not a futures commission merchant may trade for its own account or any proprietary account, as defined by the Commission, and if the Commission determines that such trades shall be permitted, the Commission shall further determine the terms, conditions, and circumstances under which such trades shall be conducted: Provided, That any such determination, at a minimum, shall take into account the effect upon the liquidity of trading of each market: And provided further, That nothing herein shall be construed to prohibit the Commission from making separate determinations for different contract markets when such are warranted in the judgment of the Commission, or to prohibit contract markets from setting terms and conditions more restrictive than those set by the Commission.

Sec. 4k. (1) It shall be unlawful for any person to be associated with any futures commission merchant or with any introducing broker ~~[agent of a futures commission merchant~~] as a partner, officer, or employee (or any person occupying a similar status or performing similar functions), in any capacity which involves (i) the solicitation or acceptance of customers' orders (other than in a clerical capacity) or (ii) the supervision of any person or persons so engaged, unless such person shall have registered, under this Act, with the Commission as an associated person of such futures commission merchant or introducing broker and such registration shall not have expired nor been suspended (and the period of suspension has not expired) or revoked, and it shall be unlawful for any futures commission merchant or introducing broker ~~[any agent of a futures commission merchant~~] to permit such a person to become or remain associated with him in any such capacity if such futures commission merchant or introducing broker ~~[agent]~~ knew or should have known that such person was not so registered or that such registration had expired, been suspended (and the period of suspension has not expired) or revoked: Provided, That any individual who is registered under any other provision of this Act or the rules of the Commission ~~[as a floor broker or futures commission merchant~~] (and such registration is not suspended or revoked) need not also register under ~~[these]~~ this provision~~[s]~~; and provided further that no person shall be required to register as an associated person of both a futures commission merchant and an introducing broker.

(2) It shall be unlawful for any person to be associated with any commodity pool as a partner, officer, employee or agent (or any person occupying a similar status or performing similar functions), in any capacity which involves (i) the solicitation or acceptance of a participant's or prospective participant's money, securities or property (other than in a clerical capacity) or (ii) the placing or monitoring of trading instructions on behalf of the commodity pool (other than in a clerical capacity) or (iii) the supervision of any person or persons so engaged, unless such person shall have registered under this Act with the Commission and such registratation shall not have expired nor been suspended (and the period of suspension has not expired) or revoked, and it shall be unlawful for any commodity pool to permit such a person to become or remain associated with it in any such capacity if such commodity pool knew or should have known that such person was not so registered or that such registration had expired, been suspended (and the period of suspension has not expired) or revoked: Provided, That any individual who is registered under any other provision of this Act or the rules of the Commission (and such registration is not suspended or revoked) need not also register under this provision.

(3) It shall be unlawful for any person to be associated with any commodity trading advisor as a partner, officer, employee or agent

(or any person occupying a similar status or performing similar functions), in any capacity which involves (i) the solicitation or acceptance of a client or a prospective client (other than in a clerical capacity) or (ii) the directing or placing of orders for the purchase or sale of commodity interests on behalf of a client (other than in a clerical capacity) or (iii) the supervision of any person or persons so engaged, unless such person shall have registered under this Act with the Commission and such registration shall not have expired nor been suspended (and the period of suspension has not expired) nor revoked, and it shall be unlawful for any commodity trading advisor to permit such a person to become or remain associated with him in any such capacity if such commodity trading advisor knew or should have known that such person was not so registered or that such registration had expired, been suspended (and the period of suspension has not expired) or revoked: Provided, That any individual who is registered under any other provision of this Act or the rules of the Commission (and such registration is not suspended or revoked) need not also register under this provision.

[~~(2)~~] (4) Any [~~such~~] person desiring to be registered as an associated person of a futures commission merchant, introducing broker, a commodity pool or a commodity trading advisor pursuant to this section shall make application to the Commission in the form and manner prescribed by the Commission, giving such information and facts as the Commission may deem necessary or appropriate in order to determine whether the applicant is qualified for registration [~~concerning the applicant~~]. Such person, when registered hereunder, shall likewise continue to report and furnish to the Commission such information as the Commission may require. Such registration shall expire two years after the effective date thereof or at such other time, not less than one year from the date of issuance thereof, as the Commission may by rule, regulation, or order prescribe and shall be renewed upon application therefor, unless the registration has been suspended (and the period of such suspension has not expired) or revoked after notice and hearing as prescribed in section 6(b) of this Act: Provided, That upon initial registration, unless the Commission otherwise prescribes by rule, regulation, or order, the effective period of such registration shall be not more than two years nor less than one year from the effective date thereof.

[~~(3)~~] (5) The Commission may authorize a registered futures association to perform any portion of the registration functions under this section, in accordance with rules approved by the Commission, and subject to the provisions of this Act applicable to registrations granted by the Commission.

[~~Sec. 4l. It is hereby found that the activities of commodity trading advisors and commodity pool operators are affected with a national public interest in that, among other things—~~

~~(1) their advice, counsel, publications, writings, analyses, and reports are furnished and distributed, and their contracts, solicitations, subscriptions, agreements, and other arrangements with clients take place and are negotiated and performed by the use of the mails and other means and instrumentalities of interstate commerce;~~

~~(2) their advice, counsel, publications, writings, analyses, and reports customarily relate to and their operations are directed toward and cause the purchase and sale of commodities for future delivery on or subject to the rules of contract markets; and~~

~~(3) the foregoing transactions occur in such volume as to affect substantially transactions on contract markets.~~]

Sec. 4l. It shall be unlawful for any person to manipulate the price of any commodity in interstate commerce, or for future delivery on or subject to the rules of any contract market, or to corner any such commodity.

Sec. 4m It shall be unlawful for any commodity trading advisor or commodity pool [~~operator~~], unless registered under this Act, to make use of the mails or any means or instrumentality of interstate commerce in connection with [~~his~~] its business [~~as~~] of such commodity trading advisor or commodity pool [~~operator~~]: Provided, That the foregoing provisions of this section shall not apply to any commodity trading advisor (i) who, during the course of the preceding twelve months, has not furnished commodity trading advice to more than fifteen persons and who does not hold himself out generally to the public as a commodity trading advisor[~~.~~], [~~The provisions of this section shall not apply to any commodity trading advisor~~] (ii) who is a [~~(1)~~] dealer, processor, broker, or seller in cash market transactions of any enumerated commodity [~~specifically set forth in section 2(a) of this Act prior to the enactment of the Commodity Futures Trading Commission Act of 1974~~] (or products thereof) or [~~(2)~~] (iii) which is a nonprofit, voluntary membership, general farm organization [~~, who~~] which provides advice on the sale or purchase of any enumerated commodity [~~specifically set forth in section 2(a) of this Act prior to the enactment of the Commodity Futures Trading Commission Act of 1974~~], if the advice by the person described in clause [~~(1) or (2)~~] (ii) or (iii) of this sentence as a commodity trading advisor is solely incidental to the conduct of that person's business: and Provided, further, That [~~such person~~] any commodity trading advisor referred to in clause (i), (ii) or (iii) shall be subject to proceedings under section 14 of this Act.

Sec. 4n(1) Any commodity trading advisor or commodity pool [~~operator~~], or any person who contemplates becoming a commodity trading advisor or commodity pool [~~operator~~], may register under this Act by filing an application with the Commission. Such application shall contain such information, in such form and detail, as the Commission may, by rules and regulations, prescribe as necessary or appropriate in order to determine whether the applicant is qualified for registration. [~~the public interest, including the following:~~

~~(A) the name and form of organization, including capital structure, under which the applicant engages or intends to engage in business; the name of the State under the laws of which he is organized; the location of his principal business office and branch offices, if any; the names and addresses of all partners, officers, directors, and persons performing similar functions or, if the applicant be an individual, of such individual; and the number of employees;~~

~~(B) the education, the business affiliations for the past ten years, and the present business affiliations of the applicant and of his partners, officers, directors, and persons performing similar functions and of any controlling person thereof;~~

~~(C) the nature of the business of the applicant, including the manner of giving advice and rendering of analyses or reports;~~

~~(D) the nature and scope of the authority of the applicant with respect to clients' funds and accounts;~~

~~(E) the basis upon which the applicant is or will be compensated; and~~

~~(F) such other information as the Commission may require to determine whether the applicant is qualified for registration.~~]

(2) Each registration under this section shall expire on the 30th day of June of each year, or at such other time, not less than one year from the effective date thereof, as the Commission may by rule, regulation, or order prescribe, and shall be renewed upon application therefor subject to the same requirements as in the case of an original application.

(3) [~~(A)~~] Every commodity trading advisor and commodity pool [~~operator~~] [~~registered under this Act~~] shall maintain such books and records, make such disclosures and file such reports in such form and manner as may be prescribed by the Commission. All such books and records shall be kept for a period of at least three years, or longer if the Commission so directs, and shall be open to inspection by any representative of the Commission or the Department of Justice. Upon the request of the Commission, a [~~registered~~] commodity trading advisor or commodity pool [~~operator~~] shall furnish the name and address of each client, subscriber, or participant, and submit samples or copies of all reports, letters, circulars, memorandums, publications, writings, or other literature or advice distributed to clients, subscribers, or participants, or prospective clients, subscribers, or participants.

[~~(B) Unless otherwise authorized by the Commission by rule or regulation, all commodity trading advisors and commodity pool operators shall make a full and complete disclosure to their subscribers, clients, or participants of all futures market positions taken or held by the individual principals of their organization.~~]

(4) Every commodity pool [~~operator~~] shall regularly furnish statements of account to each participant in [~~his~~] its operations. Such statements shall be in such form and manner as may be prescribed by the Commission and shall include complete information as to the current status of all trading accounts in which such participant has an interest.

[~~(5) The Commission is authorized, without hearing, to deny registration to any person as a commodity trading advisor or commodity pool operator if such person is subject to an outstanding order under this Act denying to such person trading privileges on any contract market, or suspending or revoking the registration of such person as a commodity trading advisor, commodity pool operator, futures commission merchant, or floor broker, or suspending or expelling such person from membership on any contract market.~~

~~(6) The Commission after hearing may by order deny registration, revoke or suspend the registration of any commodity trading advisor or commodity pool operator if the Commission finds that such denial, revocation, or suspension is in the public interest and that—~~

~~(A) the operations of such person disrupt or tend to disrupt orderly marketing conditions, or cause or tend to cause sudden or unreasonable fluctuations or unwarranted changes in the prices of commodities;~~

~~(B) such commodity trading advisor or commodity pool operator, or any partner, officer, director, person performing similar function or controlling person thereof—~~

~~(i) has within ten years of the issuance of such order been convicted of any felony or misdemeanor involving the purchase or sale of any commodity or security, or arising out of any conduct or practice of such commodity trading advisor or commodity pool operator or affiliated person as a commodity trading advisor or commodity pool operator; or~~

~~(ii) at the time of the issuance of such order, is permanently or temporarily enjoined by order, judgment or decree of any court of competent jurisdiction from acting as a commodity trading advisor, commodity pool operator, futures commission merchant, or floor broker, or as an affiliated person or employee of any of the foregoing, or from engaging in or continuing any conduct or practice in connection with any such activity or in connection with the purchase or sale of commodities or securities; or~~

~~(C) any partner, officer, or director of such commodity trading advisor or commodity pool operator, or any person performing a similar function or any controlling person thereof is subject to an outstanding order of the Commission denying trading privileges on any contract market to such person, or suspending or revoking the registration of such person as a commodity trading advisor, commodity pool operator, futures commission merchant, or floor broker, or suspending or expelling such person from membership on any contract market.~~]

Sec. 4o. (1) It shall be unlawful for any commodity trading advisor or commodity pool [~~operator~~], or any principal or associated person of a commodity trading advisor or commodity pool, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

(A) to employ any device, scheme, or artifice to defraud any client or participant or prospective client or participant; or

(B) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or participant or prospective client or participant.

(2) It shall be unlawful for any commodity trading advisor or commodity pool operator [~~registered under this Act~~] to represent or imply in any manner whatsoever that he or it has been sponsored, recommended, or approved, or that his abilities or qualifications have in any

respect been passed upon, by the United States or any agency or officer thereof: Provided, That this section shall not be construed to prohibit a statement that a person is registered under this Act as a commodity trading advisor or commodity pool [~~operator~~], if such statement is true in fact and if the effect of such registration is not misrepresented.

Sec. 4p. The Commission may specify by rules and regulations appropriate standards with respect to training, experience, and such other qualifications as the Commission finds necessary or desirable to insure the fitness of futures commission merchants, introducing brokers, floor brokers, and those persons associated with futures commission merchants, introducing brokers, or floor brokers. In connection therewith, the Commission may prescribe by rules and regulations the adoption of written proficiency examinations to be given to applicants for registration as futures commission merchants, introducing brokers, floor brokers, and those persons associated with futures commission merchants, introducing brokers, or floor brokers, and the establishment of reasonable fees to be charged to such applicants to cover the administration of such examinations. The Commission may further prescribe by rules and regulations that, in lieu of examinations administered by the Commission, futures associations registered under section 17 of this Act or contract markets may adopt written proficiency examinations to be given to applicants for registration as futures commission merchants, introducing brokers, floor brokers, and those persons associated with futures commission merchants, introducing brokers, or floor brokers, and charge reasonable fees to such applicants to cover the administration of such examinations. Notwithstanding any other provision of this section, the Commission may specify by rules and regulations such terms and conditions as it deems appropriate to protect the public interest wherein exception to any written proficiency examination shall be made with respect to individuals who have demonstrated, through training and experience, the degree of proficiency and skill necessary to protect the interests of the customers of futures commission merchants, introducing brokers, and floor brokers.

Sec. 5. The Commission is hereby authorized and directed to designate any board of trade as a "contract market" when, and only when, such board of trade complies with and carries out the following conditions and requirements:

* * * *

(b) When the governing board thereof provides for the making, [~~and~~] filing, and retaining by the board or any member thereof, [~~as the Commission may direct,~~] of such reports and records [~~in accordance with the rules and regulations, and~~] in such manner and form and at such times as the Commission may [~~be~~] prescribe[d] by [~~the Commission,~~] rule showing the details and terms of all transactions entered into by [~~the board, or~~] the members thereof, either in cash transactions or contracts [~~transactions~~] for future delivery [~~consummated~~] traded or executed on or subject to the rules of a broad of trade, or transactions for future delivery. [~~and when such governing board provides, in accordance with such rules and regulations, for the keeping of a record by the board or the members of the board of trade, as the Commission may direct, showing the details and terms of all cash and future transactions entered into by them, consummated on or subject to the rules of a board of trade, such record to be in permanent form, showing the parties to all such transactions, including the persons for whom made, any assignments or transfers thereof, with the parties thereto, and the manner in which said transactions are fulfilled, discharged, or terminated.~~] [~~Such~~] Any record [~~shall be~~] required by the Commission to be [~~kept~~] made shall be retained for a period of three years from the date thereof, or for [~~a~~] such longer period [~~if~~] as the Commission [~~shall so direct,~~] may prescribe by rule and shall at all times be open to [~~the~~] inspection [~~of~~] by any representative of the Commission or the United States Department of Justice.

(c) When the governing board thereof provides for the prevention of dissemination by the board of any member thereof, of false or misleading or knowingly inaccurate reports concerning crop or market information or conditions that affect or tend to affect the price of commodities [~~in interstate commerce~~] underlying any contract for future delivery made or executed on or subject to the rules of such board of trade.

* * * *

(f) When the governing board provides for making effective the final orders or decisions entered pursuant to the provisions of paragraph (b) section 6, and the orders issued pursuant to the provisions of section 5a of this Act, which relate to contracts for future delivery made or executed on or subject to the rules of such board of trade and for compliance in all other respects with the requirements applicable to [~~such board of trade~~] contract markets under this Act.

* * * *

Sec. 5a. Each contract market shall—

(1) promptly furnish to the Commission copies of all bylaws, rules, regulations, and resolutions made or issued by it or by the governing board thereof or any committee, and of all changes and proposed changes therein;

(2) keep all books, records, minutes, and journals of proceedings of such contract market, and its governing board, committees, subsidiaries, and affiliates in a manner that will clearly describe all matters discussed by such contract market, governing board, committees, subsidiaries and affiliates and reveal any action taken in such matters, and allow inspection at all times by any authorized representative of the Commission or the United States Department of Justice of all such books, records, minutes, and journals of proceedings. Such books, records, minutes, and journals of proceedings shall be kept for a period of three years, [~~from the date thereof,~~] or for [~~a~~] such longer period [~~if~~] as the Commission [~~shall so direct~~] may by rule prescribe;

(3) require the operators of warehouses in which or out of which any commodity is deliverable on any contract for future delivery made or executed on or subject to the rules of such contract market, to make such reports, keep such books and records, and permit such warehouse visitation as the Commission may prescribe. Such books and records shall be required to be kept for a period of three years[~~, from the date thereof,~~] or for [~~a~~] such longer period [~~if~~] as the Commission may by rule prescribe, [~~shall so direct,~~] and such books, records, and warehouses shall be open at all times to inspection by any representative of the Commission or the United States Department of Justice;

(4) when so directed by order of the Commission, provide for a period, after trading in contracts of sale of any commodity for future delivery in a delivery month has ceased, during which contracts of sale of such commodity for future delivery in such month may be satisfied by the delivery of the actual cash commodity. Whenever, after [~~due~~] notice and opportunity for hearing, the Commission finds that provision for such a period of delivery for any one or more commodities or markets would prevent or tend to prevent "squeezes" and market congestion endangering price stability, it shall require by order such period of delivery (which shall be not less than three nor more than ten business days) applicable to such commodities and markets as it finds will prevent or tend to prevent such "squeezes" and market congestion: Provided, however, That such order shall not apply to then existing contracts;

(5) require the party making delivery of any commodity on any contract of sale of such commodity for future delivery to furnish the party obligated under the contract to accept delivery, written notice of the date of delivery at least one business day prior to such date of delivery. Whenever, after [~~due~~] notice and opportunity for hearing, the Commission finds that the giving of longer notice of delivery is necessary to prevent or diminish unfair practices in trading in any one or more commodities or markets, it shall require by order such longer notice of delivery (which shall be not more than ten business days) applicable to such commodities and markets as it finds will prevent or diminish such unfair practices: Provided, however, That such order shall not apply to then existing contracts;

(6) require that all contracts of sale of any commodity for future delivery on such contract market shall provide for the delivery thereunder of commodities of grades conforming to United States standards, if such standards shall have been [~~officially promulgated and~~] adopted by the Commission;

* * * *

Sec. 6(b) If the Commission has reason to believe that any person (other than a contract market) is manipulating or has manipulated or attempted to manipulate the market price of any commodity, in interstate commerce, or commodity interests [~~for future delivery on or subject to the rules of any contract market~~], or has willfully made any false or misleading statement of a material fact in any registration application or any report filed with the Commission under this Act, or willfully omitted to state in any such application or report any material fact which is to be stated therein, or otherwise is violating or has violated any of the provisions of this Act or of the rules, regulations, or orders of the Commission thereunder, it may serve upon such person a complaint stating its charges in that respect, which complaint shall have attached or shall contain therein a notice of hearing, specifying a day and place not less than three days after the service thereof, requiring such person to show cause why an order should not be made prohibiting him from trading on or subject to the rules of any contract market, and directing that all contract markets refuse all trading privileges to such person, until further notice of the Commission, and to show cause why the registration of such person, if registered as futures commission merchant, introducing broker [~~or any person associated therewith as described in section 4k of this Act~~], commodity trading advisor, commodity pool [~~operator~~], associated person or [~~as~~] floor broker hereunder, should not be suspended or revoked. . . .

* * * *

Sec. 8a. The Commission is authorized—

(1) to register any persons required or permitted to be registered under the Act or the rules of the Commission [~~futures commission merchants and persons associated therewith as described in section 4k of this Act, commodity trading advisors, commodity pool operators and floor brokers~~] upon application in accordance with rules and regulations and in form and manner to be prescribed by the Commission, which may require the applicant, and any persons associated with the applicant as the Commission may specify, to be fingerprinted and to submit, or cause to be submitted, such fingerprints to the Attorney General for identification and appropriate processing; [~~and~~]

[~~(2) to refuse to register any person—~~

~~(A) if the prior registration of such person has been suspended (and the period of such suspension shall not have expired) or has been revoked;~~

~~(B) if it is found, after opportunity for hearing, that the applicant is unfit to engage in the business for which the application for registration is made, (i) because such applicant, or, if the applicant is a partnership, any general partner, or, if the applicant is a corporation, any officer or holder of more than 10 per centum of the stock, at any time engaged in any practice of the charatur prohibited by this Act or was convicted of a felony in any State or Federal court, or was debarred by any agency of the United States from contracting with the United States, or the applicant willfully made any material false or misleading statement in his application or willfully omitted to state any material fact in connection with the application, or (ii) for other good cause shown; or~~

~~(C) in the case of an applicant for registration as futures commission merchant, if it is found after opportunity for hearing that the applicant has not established that he meets the minimum financial requirements under section 4f of this Act; Provided, that pending final determination under clause (B) or (C), registration shall not be granted: And provided further, That the applicant may appeal from a refusal of registration under clause (B) or (C) in the manner provided in paragraph (b) of section 6 of this Act; and~~

~~(3) in accordance with the procedure provided for in paragraph (b) of section 6 of this Act, to suspend or revoke the registration of any person registered under this Act if cause exists under subparagraph (2) (B) or (C) which would warrant a refusal of registration of such person, and to suspend or revoke the registration of any futures commission merchant who shall knowingly accept any order for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market from any person if such person has been denied trading privileges on any contract market by order of the Commission under the provisions of paragraph (b) of Section 6 of this Act and the period of denial specified in such order shall not have expired; and~~]

(2) without opportunity for a hearing, to refuse to register any person if such person is subject to an outstanding order of the Commission: (a) suspending or revoking a prior registration; (b) prohibiting such person from trading on any contract market; or (c) suspending or expelling such person from membership on any contract market;

(3) after notice and opportunity for hearing, to refuse to register or to deny, suspend or revoke the registration of, any person upon finding that such denial, suspension or revocation is in the public interest and upon finding:

(a) that such person (i) has at any time violated any provision of this Act, (ii) has been convicted within the previous ten years of a felony or misdemeanor in any State or Federal court involving the purchase or sale of any commodity or security or arising out of any activity of any person required to be registered by the Commission, (iii) has been debarred or prohibited by any agency of the United States from contracting with the United States, or (iii) has wilfully made any material false or misleading statement or has omitted to state any material fact in connection with the application for registration; or

(b) that such person is permanently or temporarily enjoined by order, judgment or decree of any court of competent jurisdiction from acting in any capacity requiring registration by the Commission or as an employee or other affiliated person of any person acting in any such capacity, or from engaging in or continuing any conduct or practice in connection with any such activity or in connection with the purchase or sale of commodities or securities; or

(c) that such person is unfit to engage in the business for which application is made or registration was granted as defined by the Commission by rule; or

(d) in the case of a futures commission merchant:

(i) that the applicant or registrant has not established that he meets the minimum financial standards prescribed under section 4f of the Act and the rules of the Commission; or

(ii) that such person has knowingly accepted an order for the purchase or sale of any commodity interest from another person that is the subject of an order of the Commission prohibiting such other person from trading on any contract market; or

(e) in the case of a commodity trading advisor or commodity pool:

(i) that the operations of such person disrupt or tend to disrupt orderly marketing conditions, or cause or tend to cause sudden or unreasonable fluctuations or unwarranted changes in the price of commodities; or

(ii) that any principal of such person is subject to an outstanding order of the Commission denying trading privileges on any contract market to such person, or suspending or revoking the registration of such person under the Act, or suspending or expelling such person from membership on any contract market;

* * * *

(8) to make and promulgate such rules and regulations with respect to those persons registered or required to be registered under this Act, who are not members of a contract market, as in the judgment of the Commission are reasonably necessary to protect the public interest and promote just and equitable principles of trade,

including but not limited to the manner, method and place of soliciting business including the content of such solicitations; [~~and~~]

* * * *

(10) to exempt, by rule, regulation or order, conditionally or unconditionally, any person or transaction, or any class or classes of persons or transactions, from any provision or provisions of this Act or of any rules or regulations thereunder, if and to the extent that it finds that such exemption is not contrary to the public interest and is consistent with the purposes intended by this Act.

* * * *

Sec. 8(d) The Commission, upon its own initiative or in cooperation with existing governmental agencies, shall [~~investigate the marketing conditions of commodities and commodity products and byproducts, including supply and demand for these commodities, cost to the consumer, and handling and transportation charges. It shall also compile and furnish to producers, consumers, and distributors~~] conduct regular investigations of the markets for goods, articles, services, rights and interests which are the subject of futures contracts traded in the United States, and report the findings of these investigations to the public by means of regular or special reports, or by such other methods as it deems most effective. Such reports shall, where appropriate, include information respecting the commodity markets, together with information on the supply, demand, prices, and other conditions in this and other countries that affect the markets.

* * * *

Sec. 8c. (1)(A) Any [~~exchange~~] contract market or the Commission if the [~~exchange~~] contract market fails to act, may suspend, expel, or otherwise discipline any person who is a member of that [~~exchange~~] contract market, or deny any person access to the [~~exchange~~] contract market. Any such action shall be taken solely in accordance with the rules of that [~~exchange~~] contract market.

(B) Any suspension, expulsion, disciplinary, or access denial procedure established by [~~an exchange~~] a contract market rule shall provide for written notice to the Commission and to the person who is suspended, expelled, or disciplined, or denied access, within thirty days, which includes the reasons for the [~~exchange~~] contract market action in the form and manner the Commission prescribes. [~~An exchange~~] A contract market shall make public its findings and the reasons for the [~~exchange~~] contract market action in any such proceeding, including the action taken or the penalty imposed, but shall not disclose the evidence therefor, except to the person who is suspended, expelled, or disciplined, or denied access, and to the Commission.

(2) The Commission may, in its discretion and in accordance with such standards and procedures as it deems appropriate, review any decision by [~~an exchange~~] a contract market whereby a person is suspended, expelled, otherwise disciplined, or denied access to the [~~exchange~~] contract market. In addition, the Commission may, in its discretion and upon application of any person who is adversely affected by any other [~~exchange~~] contract market action, review such action.

(3) The Commission may affirm, modify, set aside, or remand any [~~exchange~~] contract market decision it reviews pursuant to subsection (2), after a determination on the record whether the action of the [~~exchange~~] contract market was in accordance with the policies of this Act. Subject to judicial review, any order of the Commission entered pursuant to subsection (2) of this section shall govern the [~~exchange~~] contract market in its further treatment of the matter.

* * * *

Sec. 16. [~~(a) The Commission may conduct regular investigations of the markets for goods, articles, services, rights, and interests which are the subject of futures contracts, and furnish reports of the findings of these investigations to the public on a regular basis. These market reports shall, where appropriate, include information on the supply, demand, prices, and other conditions in the United States and other countries with respect to such goods, articles, services, rights, interests, and information respecting the futures markets.~~]

[~~(b)~~] (a) The Commission shall cooperate with the Department of Agriculture and any other Department or Federal agency which makes market investigations to avoid unnecessary duplication of information-gathering activities.

[~~(c)~~] (b) The Department of Agriculture and any other Department or Federal agency which has market information sought by the Commission shall furnish it to the Commission upon the request of any authorized employee of the Commission. The Commission shall abide by any rules of confidentiality applying to such information.

[~~(d)~~] (c) The Commission shall not disclose in such reports data and information which would separately disclose the business transactions of any person and trade secrets or names of customers except as provided in section 8 of this Act.

* * * *

Sec. 19. (a) No person shall offer to enter into, enter into, or confirm the execution of, a leverage transaction for an enumerated commodity. [~~any transaction for the delivery of any commodity specifically set forth in section 2(a) of this Act prior to the enactment of the Commodity Futures Trading Commission Act of 1974 under a standardized contract commonly known to the trade as a margin account, margin contract, leverage account, or leverage contract, or under any contract, account, arrangement, scheme, or device that the Commission determines serves the same function or functions as such a standardized contract, or is marketed or managed in substantially the same manner as such a standardized contract.~~]

(b) No person shall offer to enter into, enter into, or confirm the execution of any leverage transaction for the delivery of silver bullion, gold bullion, or bulk silver coins or bulk gold coins, [~~under a standardized contract described in subsection (a) of this section,~~] contrary to any rule, regulation, or order of the Commission designed to ensure the financial solvency of the transaction or prevent manipulation or fraud: Provided, That such rule, regulation, or order may be made only after notice and opportunity for hearing.

(c) The Commission may prohibit or regulate any leverage transactions [~~under a standardized contract~~] described in subsection (a) of this section, involving any [~~other~~] commodities other than (i) enumerated commodities and (ii) those commodities referred to in subsection (b) of this section under such terms and conditions as the Commission shall initially prescribe by October 1, 1979: Provided, That such rule, regulation, or order may be made only after notice and opportunity for hearing: Provided further, That the Commission may set different terms and conditions for [~~such~~] leverage transactions involving different commodities.

(d) If the Commission determines that any leverage transaction [~~under subsections (b) and (c) of this section~~] is a contract for future delivery within the meaning of this Act, such leverage transaction shall be regulated in accordance with the applicable provisions of this Act.

* * * *

Sec. 19. (a) [~~Notwithstanding~~] Consistent with title 11 of the United States Code, the Commission may provide, with respect to a commodity broker that is a debtor under chapter 7 of title 11 of the United States Code, by rule or regulation -

(1) that certain cash, securities, other property, or commodity contracts are to be included in or excluded from customer property or member property;

(2) that certain cash, securities, other property or commodity contracts are to be specifically identifiable to a particular customer in a specific capacity;

(3) the method by which the business of such commodity broker is to be conducted [~~or liquidated~~] pending liquidation after the date of the filing of the petition under such chapter;

(4) any persons to which customer property and commodity contracts may be transferred under section 766 of title 11 of the United States Code; and

(5) how the net equity of a customer is to be determined.

(b) As used in this section, the terms 'commodity broker', 'commodity contract', 'customer', 'customer property', 'member property', 'net equity', and 'security' have the meanings assigned such terms for the purposes of subchapter IV of chapter 7 of title 11 of the United States Code.

AMERICAN BAR ASSOCIATION

Committee on Commodities Regulation

OFFICERS

Edmund R. Schroeder,
Chairman

Barrett Smith Schapiro
Simon & Armstrong
26 Broadway (Suite 1400)
New York, New York 10004
212-422-8180

Charles E. Hord,
Secretary

Barrett Smith Schapiro
Simon & Armstrong
26 Broadway (Suite 1400)
New York, New York 10004
212-422-8180

John V. Rainbolt, II,
Program Coordinator

1800 K Street, N.W.
Washington, D.C. 20006
202-466-8001

SUBCOMMITTEE CHAIRMEN

Administrative and Judicial Proceedings

Mahlon M. Frankhauser

Kirkland & Ellis
Suite 1100
1776 K Street, N.W.
Washington, D.C. 20006
202-857-5120

Bankruptcy

Franklin Feldman

Stroock & Stroock & Lavan
61 Broadway
New York, New York 10006
212-425-5200

EXHIBIT B

CFTC Structure and Functions

Terry L. Claassen

O'Neal & Claassen
Suite 952
600 New Hampshire Avenue, N.W.
Washington, D.C. 20037
202-338-2100

Commodity Pool Operators and Commodity Trading Advisors

Howard Schneider

Rosenman Colin Freund
Lewis & Cohen
575 Madison Avenue
New York, New York 10022
212-940-8787

Futures Commission Merchants and Associated Persons

Lawrence H. Hunt, Jr.

Sidley & Austin
One First National Plaza
Chicago, Illinois 60603
312-853-7000

Jurisdictional Matters

Edwin L. Lyon

Cadwalader Wickersham
& Taft
1333 New Hampshire
Avenue, N.W.
Washington, D.C. 20036
202-466-1249

Self-Regulatory Bodies

John H. Stassen

Kirkland & Ellis
Standard Oil Building
200 East Randolph Drive
Chicago, Illinois 60601
312-861-2238

Options and Leverage Transactions

Stephen F. Selig

Baer Marks & Upham
299 Park Avenue
New York, New York 10017
212-832-1700

Statutory Organizations and Definitions

Richard E. Nathan

Marshall Bratter Greene
Allison & Tucker
430 Park Avenue
New York, New York 10022
212-421-7200

STATEMENT OF THOMAS A. RUSSO, CHAIRMAN, THE COMMITTEE ON COMMODITIES REGULATION OF THE ASSOCIATION OF THE BAR OF THE CITY OF NEW YORK

Mr. Chairman and members of the Committee, I want to thank you for giving us the opportunity to present the views of the Committee on Commodities Regulation of The Association of the Bar of the City of New York. My name is Thomas Anthony Russo and I am presently Chairman of that Committee. I am currently a partner at the law firm of Cadwalader, Wickersham & Taft and was formerly Deputy General Counsel of the Commodity Futures Trading Commission ("CFTC") and the CFTC's first Director of the Division of Trading and Markets. I was at the CFTC from June 1975 to April 1977.

The Committee on Commodities Regulation of the Association of the Bar of the City of New York consists of 16 members, and, in my view, represents a cross section of the commodities bar of the City of New York. A list of the members of the Committee is attached to this Committee's testimony.

For its 1981-1982 project, the Committee has been considering three issues that are pertinent to the reauthorization of the CFTC. These issues are: (i) the regulation of commodity pools; (ii) the reparations process of the CFTC; and (iii) the standards of conduct imposed on commodity industry professionals by the Commodity Exchange Act (the "Act"). We decided to study these issues because we felt that they would not be a primary focus for most participants in the reauthorization process and therefore might not receive the thoughtful consideration we believe they merit.

In conjunction with this project, we divided the 16-person Committee into three subcommittees. The Subcommittee studying commodity pool regulation is chaired by Howard Schneider, a senior partner at the law firm of Rosenman, Colin, Freund, Lewis & Cohen and the first General Counsel of the CFTC. The Subcommittee considering the standard of conduct issue is chaired by Richard E. Nathan, a partner at the law firm of Marshall, Bratter, Greene, Allison & Tucker. Mr. Nathan was Deputy General Counsel of the CFTC and, subsequent to Mr. Schneider's departure from the CFTC, served as Acting General Counsel. Finally, the Subcommittee studying the reparations process is chaired by Charles Nastro, Executive Vice President and Counsel to the Commodity Division of Shearson/American Express Inc.

Each Subcommittee Chairman will present the views of his Subcommittee. The reports of the latter two Subcommittees were approved by the full Committee on Commodities Regulation, with no dissenting votes. The report submitted by Mr. Schneider's Subcommittee also was approved by each member of the full Committee, save for one dissenting vote. That report strongly advocates the exclusive federal regulation of commodity pools, and the one dissenting vote was cast by Eugene Berman, who is with the New York State Department of Law. Mr. Berman's dissent is based upon his belief that, as a matter of public policy, state regulation of commodity pools should not be preempted by the Commodity Exchange Act. He would prefer the Act to provide a savings clause for state regulation not in conflict with the Act, such as is contained in the Investment Company Act of 1940.

Each of the oral presentations to be given today by the Subcommittee Chairmen will be approximately five minutes in length. These oral presentations will be supplemented with formal reports that we anticipate submitting to the Committee, for the record, within the next month. Those reports represent the expenditure of many hundreds of hours of time by the Committee members, in an effort to bring their expertise to bear on issues that are relevant to the reauthorization process. It is hoped that our presentation today, together with the Subcommittees' written reports, will make a constructive contribution to this process and will be of some use to this Committee, and to the Congress as a whole, as they strive to refine and improve the Commodity Exchange Act.

The first speaker will be Subcommittee Chairman Howard Schneider.

STATEMENT OF HOWARD SCHNEIDER
Re: COMMODITY POOL ISSUES

Mr. Chairman and members of the Committee, thank you for the opportunity to be here today.

My name is Howard Schneider; I am a senior partner in the law firm of Rosenman Colin Freund Lewis & Cohen and a former General Counsel of the Commodity Futures Trading Commission ("CFTC"). I am currently serving the Commodities Committee of the Association of the Bar of the City of New York as a Subcommittee Chairman dealing with the impact of the Investment Company Act of 1940 and Investment Advisers Act of 1940 (collectively, the "'40 Acts"), as administered by the Securities and Exchange Commission ("SEC"), on the operation of commodity pools.

Since our time is short, I will try to be brief. In light of the substantial growth of commodity pools as investment vehicles and in the absence of any history of investor claims of fraud or abusive practices with regard to SEC registered commodity pools, I would like to raise two specific points in connection with reauthorization and its implications in the commodity pool area:

First: Congress should explicitly reiterate, preferably by a statutory provision, CFTC preemption of all State regulation of commodity pools; and

Second: Congress should make clear, possibly by a statement in the Congressional Record, that commodity pools are not subject to the '40 Acts unless they and their advisors engage in activities (in more than a de minimus way) over which the SEC has explicit statutory jurisdiction; or, stated conversely, so long as commodity pools and their advisors deal in and with futures contracts and options on futures contracts, whatever the characterization of the underlying commodity which is traded (i.e., whether regarded by the SEC as a "security" or not), the '40 Acts are inapplicable. Congress should also direct the SEC and CFTC to work out the demarcation line between activities of a commodity pool which are de minimus and those which are substantial enough to warrant the '40 Acts applicability.

My concern in the first area arises as a result of the joint CFTC/SEC proposal to amend §4m of the Commodity Exchange Act and my concern in the second area arises as a result of a seemingly innocuous sentence at the end of the Joint Explanatory Statement submitted by the CFTC and SEC (the "Joint Statement") in connection with the proposed legislative package submitted by those agencies to the Congress.

I. Background - State Regulation:

The last five years have witnessed the dramatic growth of commodity pools. Why? Because they provide significant advantages to all concerned:

1. To the person considering a modest commodity investment, they provide the advantages of limited liability, avoidance of large capital outlays, diversification, professional management, administrative convenience, reduced brokerage

commissions, and Federal regulatory oversight.

2. To the futures commission merchants involved, there are the advantages of reduction of deficit risk exposure, cost reduction, continuity, use of better qualified account executives and increased profitability.

3. To the commodity industry as a whole, commodity pools increase market liquidity and result in the introduction of new traders.

To date, these advantages have been achieved (with isolated exceptions) without investor claims of fraud or abusive practices, particularly with respect to the SEC-registered public pools.

Notwithstanding explicit Congressional statements in 1974 and 1978 (to the effect that unnecessary and duplicative regulation in the commodity area was to be avoided and that State regulation of the commodity industry was preempted), State securities administrators have insisted on qualification of commodity pools under the blue sky laws of the various jurisdictions. Moreover, many State regulators have imposed substantive regulation on commodity pools which, at times, conflict with CFTC regulations or reverse positions which the CFTC specifically considered and rejected. Additional, even more burdensome, regulation dealing primarily with compensation issues which would have the effect of drastically changing commodity pools and perhaps even eliminating them as viable entities, have been proposed by the North American Securities Administrators Association (NASAA).

The practical effect of State regulation in this area has been to increase the cost of preparing an SEC registered public pool by approximately $30-50,000, or about 20% of anticipated cost. Since the prospectus is carefully reviewed by both the SEC and CFTC and since there have been virtually no claims of abuses in this area, the States entry into the field is a clear case of regulation for regulation's sake, without any corresponding appreciable benefit (rather, an additional burden) to the investing public. Moreover, certain States, such as Texas and South Carolina, have simply refused to permit the qualification of commodity pools in their States and have, therefore, deprived the citizens of their States of the availability of this investment vehicle which the Congress has explicitly sanctioned.

Issue:

The CFTC/SEC proposed amendment to the Commodity Exchange Act [§4m(2)] makes explicit the extent of the SEC's continuing jurisdiction under the Securities Act of 1933 and the Securities Exchange Act of 1934 with respect to:

> "...the issuance, offer, purchase or sale of securities of a commodity pool, or of persons engaged in transactions with respect to such securities, or reporting by a commodity pool."

I have no quarrel with that provision as it affects the SEC. What the provision does not do, however, is make explicit that State regulation of commodity pools is preempted. That is the clear intent of the two agencies. They proclaim, in the Joint Statement, with respect to proposed §4m(2) that:

> "Of course, the proposed language would not affect the exclusive jurisdiction granted by the [Commodity Exchange Act] with respect to state regulation."

Proposed Solution:

Given the unfortunate history of State insistence on substantive regulation in connection with commodity pools, and despite clear Congressional expressions to the contrary, it is my belief that the only solution to the problem of State duplicative and unnecessary regulation of the area would be to further amend §4m(2) to make explicit CFTC preemption of State regulation. This could be accomplished by a proviso to proposed §4m(2), as follows:

> "...provided, however, that the provisions of this Act shall preclude the qualification or substantive regulation of commodity pools under the various laws of the several States dealing with the qualification or regulation of securities or otherwise in those States."

II. Background - '40 Acts Inapplicability:

The SEC has consistently taken the position that where the underlying commodity to which a futures contract relates is itself a security (even if an exempt security) then the futures contract is a "security" which would, if sufficient trading in such financial futures occurred, require registration of a commodity pool as an investment company under the Investment Company Act of 1940 and of its advisor as an investment adviser under the Investment Advisers Act of 1940. The SEC has taken this position although it is doubtful that the economic reality of a futures contract would be held to involve a security regardless of the nature of the underlying interest. The consequences of the SEC's position with respect to financial futures contracts would be to make securities law applicable to commodity pools and to change the entire character of this segment of the commodity industry.

Fortunately, the SEC retreated somewhat from this position in a "no-action" letter issued to Boston Futures Fund (I) on October 12, 1979. In that letter, the SEC continued to assert that financial futures were themselves "securities" for purposes of all of the securities laws, including the '40 Acts, but that, in light of CFTC regulation and other factors, the SEC staff would not recommend enforcement action if a commodity pool which traded such instruments did not register under the Investment Company Act or its advisor register under the Investment Advisers Act. Based on that "no-action" letter, which parenthetically was expressly limited to the financial futures then traded (GNMAs, T-Bills, T-Notes, T-Bonds and commercial paper), commodity pools and their advisors, as a practical matter, have operated without registration under the '40 Acts.

The jurisdictional accord between the CFTC and the SEC should reinforce the concept of the non-applicability of the '40 Acts to commodity pools and their advisors.

Issue:

At he end of the Joint Statement the following sentence appears:

> "Moreover, in appropriate circumstances, commodity pools and persons managing them may be subject to the Investment Advisers Act of 1940 and, if a pool conducts not only a commodities business but also acts as an investment company, the Investment Company Act of 1940."

That seemingly innocuous sentence may inadvertently serve to permit a reintroduction of the theory that the '40 Acts are somehow applicable to commodity pools and their advisors if they were to deal in financial futures contracts or options on financial futures contracts -- whether those instruments were those traded on October 12, 1979 (the date of the Boston Futures Fund "no-action" letter) or thereafter (such as, for example, futures contracts on certificates of deposits, Eurodollars and stock indices). I believe that the intent of the sentence and, indeed, the whole tenor of the CFTC/SEC accord to be that the CFTC's exclusive jurisdiction includes futures contracts of any type and options on futures contracts of any type, and that the SEC would not take or assert jurisdiction in those areas. Thus, a commodity pool and its advisor would continue to remain exempt from registration under the '40 Acts, if they dealt in futures contracts and/or options on futures contracts of any sort: It is only when the commodity pool and its advisors cross the line and invest (in more than a de minimus way) in actual securities or options on securities which are traded on a national securities exchange that the '40 Acts may apply. I assume that these are the "appropriate circumstances" referred to in the sentence quoted from the Joint Statement.

Proposed Solution:

So as to avoid any ambiguity, I would urge that a statement be placed in the Congressional Record which would make clear that, notwithstanding the last sentence of the Joint Statement, so long as commodity pools and their advisors deal in and with futures contracts and options on a futures contracts, whatever the characterization of the underlying commodity which is traded (i.e., whether regarded as a "security" or not), the '40 Acts are not applicable. Furthermore, Congress should direct the CFTC and SEC to set a clear standard of how much activity in the securities markets will require registration by a commodity pool and its advisors under the applicable '40 Acts, i.e., what is more than de minimus securities investment type activity.

While there are many other issues which impact on the '40 Acts and commodity pools, those are best left to the CFTC and SEC to work out over time. The two issues raised in this testimony, I believe, should be acted upon by the Congress so as to avoid the uncertainty which is bound to arise if they are not addressed.

Thank you.

STATEMENT OF RICHARD E. NATHAN
Re: THE STANDARDS OF CONDUCT IMPOSED UPON COMMODITY INDUSTRY PROFESSIONALS

Mr. Chairman and members of the Committee: My name is Richard E. Nathan. I am a member of the law firm of Marshall, Bratter, Greene, Allison & Tucker. Before joining that firm, I was Deputy General Counsel and Acting General Counsel to the Commodity Futures Trading Commission. I earlier served as an Assistant General Counsel to the Securities and Exchange Commission.

I am appearing here today on behalf of the Committee on Commodities Regulation of the Association of the Bar of the City of New York. The views I will express are those of the members of our Committee and do not necessarily reflect the views of the Association as a whole.

I am presently serving as chairman of a subcommittee that has considered the standards of conduct that the Commodity Exchange Act imposes upon industry professionals -- particularly with respect to anti-fraud provisions. We have compared these standards to those governing similar conduct under the Federal securities laws. We have found, in contrast to the securities laws, that the standards of conduct set forth in the Commodity Exchange Act are unreasonably broad and uncertain of application -- at least as the CFTC seeks to have them applied. In our view, Congressional action should be taken to assure a proper interpretation of the law and to eliminate the uncertainty that presently exists.

What is fundamentally involved is whether an industry professional should be subject to the apparent risk of severe administrative sanctions -- perhaps even involving the loss of his right to continue in his chosen profession -- based upon nothing more than mere negligence or even inadvertance, or whether consequences of this magnitude should flow only upon clear evidence of consciously wrongful behavior. The latter seems plainly to be the case under the federal securities laws; the former appears possibly to reflect the CFTC's interpretation of the Commodity Exchange Act.

As the Committee is aware, distinctions that have previously existed between regulation of futures marketplaces and of marketplaces for investment securities are becoming less clear. Not only are members of the securities industry participating in the futures markets in increasing numbers but the SEC and CFTC have reconciled their jurisdictional dispute with little regard to differences in the economic functions served by the markets they have historically regulated. As a result, industry professionals who deal in options and futures that are offered on substantially similar terms and that serve substantially identical economic purposes may find themselves subject to vastly different standards of conduct depending upon the essentially fortuitous circumstance whether a particular interest has been statutorily classified as a security or as a future or as a commodity option.

This problem will be most acute with respect to the application of anti-fraud standards, since violations of those provisions are more likely than others to result in the imposition of severe administrative sanctions. And if certain of the CFTC's legislative recommendations should be enacted, the problem will be greater still, since the confusion we perceive will affect many additional persons and involve vicarious as well as direct liability. As the Committee is aware, the CFTC has proposed a broad expansion of the categories of persons who will be required to register as associated persons while at the same time seeking to impose liability upon "controlling persons" for the conduct of others.

Let me provide a specific focus to these remarks. Section 4b of the Act, which is the anti-fraud provision that applies to futures commission merchants, appears plainly to proscribe behavior that is consciously wrongful. It prohibits "cheating" and "defrauding," attempts to cheat or defraud and other "willfully" false or deceptive conduct. Nevertheless, the Court of Appeals for the Ninth Circuit, in Shearson Loeb Rhoades, Inc. v. CFTC, No. 80-7212 (February 12, 1982), while recognizing that proof of a violation requires "knowledge of wrongdoing", went on to rule that this requirement may be satisfied by proof of carelessness -- "carelessly ignoring the truth." This contrasts sharply with the more common understanding of appellate courts that recklessness, at least, would be required in such a context. The uncertainty is further compounded by the decision of the CFTC that the Court upheld in that case. In an aspect of the CFTC's opinion that the Court did not address, the CFTC interpreted Section 4b "to omit intent as an element of a violation..." See Gordon v. Shearson Hayden Stone Inc., CCH Comm. Fut. L. Rep., ¶21,016 at pp. 23,977 and 23,979 (1980).

Similarly, Commission Rule 32.9, which applies to commodity option transactions, was generally patterned after Section 4b, but deliberately omits the references to "willful" behavior that Section 4b contains. This may be understood to suggest a Commission decision to treat mere inadvertence or negligence as fraud. (See 40 Fed. Reg. 26,504 at note 2 (June 17, 1975).) And Section 4o of the Commodity Exchange Act, an anti-fraud provision that applies to commodity pool operators and commodity trading advisors, has been the subject of equally expansive interpretation. In CFTC v. Savage, 611 F.2d 270 (9th Cir. 1979), the court ruled that a finding of fraud might be made even without proof of an awareness that conduct might defraud or deceive.

Of course, the unfair and unreasonable standard that the Commission has sought to apply under each of these provisions is a far cry from the standard that the Supreme Court has found applicable under the general anti-fraud provisions of Rule 10b-5 under the Securities Exchange Act of 1934. The Supreme Court has ruled that scienter must be alleged and proven. See SEC v. Aaron, 446 U.S. 680 (1980). As a result, the courts have held that no less than reckless behavior or an extreme departure from the standards of ordinary care is required to be shown.

In these circumstances we respectfully suggest that the Commodity Exchange Act be amended to limit application of these anti-fraud provisions to conscious wrongdoing or to reckless conduct. At the very least it should be made clear on the record of these reauthorization hearings that no person or firm should be in jeopardy of any of the severe administrative sanctions that the CFTC is authorized to impose based upon inadvertance or carelessness or even substantial negligence.

As matters stand now, this seems a very real risk. Based upon any violation of the Act, Section 6(d) authorizes the CFTC to deny trading privileges, to revoke or suspend the registration of any person and to impose civil penalities of up to $100,000 per violation. This may be compared to the provision of Section 15(b) of the Securities Exchange Act, which authorizes administration sanctions based only upon a prior injunction, a criminal conviction or -- explicitly -- proof in an administrative proceeding of a "willful" violation of the law.

STATEMENT OF RICHARD A. MILLER
Re: THE REPARATIONS PROCESS

Mr. Chairman and members of the Committee, thank you for the opportunity to present my views to the Subcommittee today.

My name is Richard A. Miller. I am an attorney in private practice in New York City and the publisher and editor-in-chief of the Commodities Law Letter. I am currently serving on the Committee on Commodities Regulation of the Association of the Bar of the City of New York as a member of a Subcommittee dealing with Reparations and Arbitration and I speak to you today in that capacity.

My comments concern the reparations process currently embodied in §14 of the Commodity Exchange Act.

When the reparations program originated in 1974, it was envisioned by Congress as being similar to a small claims court, and as a forum that would be capable of providing expedited redress for customer claims against commodity professionals.

Today, however, the reparations process is neither speedy, nor inexpensive, nor protective of the rights of the general public. Indeed, even from a strict budgetary viewpoint, the reparations process has become a financial white elephant that has siphoned much needed funds and personnel away from the primary duties of the CFTC.

There are four principal steps in the Reparations process, each of which has been and will continue to be a source of delays, backlog and expense at the CFTC level: (1) the screening of Complaints, (2) discovery practice, (3) adjudication by the Office of Hearings and Appeals, and (4) the Commission appellate process.

The recommendations of our Subcommittee address these problems and are the result of a thorough examination of all aspects of the reparations process. Our review was made with no bias toward retaining the procedure. In fact, we have seriously considered a recommendation to abolish reparations because the forum has not provided the type of service to the "small claim" that we believe it was intended to serve.

However, there are important countervailing considerations that lead us to believe that reparations should be retained, namely, the due process advantages and the opportunities for CFTC and judicial review.

Before addressing the specific legislative amendments that we respectfully recommend to Congress, I should mention that the Committee's study of CFTC reparations proceedings included a review of the different actions and proceedings that stand as alternatives to reparations: namely, civil litigation and arbitration proceedings. Our premise was that the costs and benefits of reparations should be weighed against the costs and benefits of these alternative procedures.

We concluded that civil litigation fails as an alternative forum to reparations because of its jurisdictional barriers, procedural complexities and clogged court calendars.

With respect to arbitration, the Committee feels strongly that arbitration will and should someday supersede reparations, particularly for smaller cases. However, the arbitration process in the commodities area has not reached a level of maturity that permits an immediate suspension of the reparations process in favor of arbitration.

Consequently, in order to improve the reparations process and to "borrow" some of the benefits of arbitration practice, we commend to the Congress a two-tier approach to reparations.

The first tier would be comprised of smaller claims where reparations would be retained but only in a setting of what would amount to a CFTC-administered arbitration forum.

Under this arrangement, Congress should permit no oral hearing, no discovery, no findings of fact, no legal opinions and no rights of appeal in cases involving claims that are less than $10,000. We believe that the procedural advantages of a written, appealable decision are more apt to become expensive disadvantages for a customer with such relatively small claims.

We envision that this first tier process would cease to function upon the initiation of a National Futures Association contemplated arbitration forum which would have jurisdiction over these small claims. Our recommendation would create substantial cost savings for the CTFC, the commodity industry and, most importantly, for the customer, and will assure the prompt redress of customer grievances.

On the other hand, the second tier of reparations would be for those customers who assert claims in excess of a jurisdictional amount of $10,000. These customers would be entitled to a full hearing before an administrative law judge, and would be able to seek review of that decision before the CFTC as well as the courts.

Aside from the establishment of the reparations forum into a two tier structure that resembles the common pattern of higher and lower courts, we recommend certain other specific proposals for all reparations matters:

First, we favor a clear statutory exemption from reparations jurisdiction for respondents who are in bankruptcy or receivership. The reparations forum is not the appropriate forum for such matters, which are more easily resolved in the bankruptcy courts. Absent this reform, claims against defunct firms will continue to clog the reparations process.

Second, as presently written, Section 14(a) provides for a two year statute of limitations. This section has been subject to conflicting interpretations. We recommend a technical change, substituting the phrase "two years after the transactions complained of." This will more positively fix the running of the statute of limitations.

Third, we endorse the current screening process under which the CFTC reviews each complaint. Although the screening process is not a source of delay at this time, it has been in the past. We therefore recommend that the CFTC be obligated to forward cases to the administrative law judges within 90 days after the filing of an answer by the respondent.

Fourth, in the appellate process, CFTC delays in deciding whether to accept a case have contributed significantly to the delay in the reparations procedure. We recommend that a reasonable period of 90 days be imposed upon the CFTC to decide whether or not to accept an application for the review of the Administrative Law Judge's Initial Decision.

Conclusion

In conclusion, we note that the CFTC, in its recent submission of proposals to Congress, has failed to address any of these widely perceived problems which have created the quagmire of the current reparations process. Rather, the CFTC has responded with a proposal that asks Congress to cede its authority and control over the reparations process to the CFTC's absolute discretion. We strongly urge that the Congress reject the Commission's legislative proposal.

It may be that the reparations process has become unmanageable and unworkable. For sure, it is a far cry from what the Congress originally envisioned. In those circumstances, Congress might reasonably conclude that alternative forums for adjudication of small claims should be made available and that the reparations process be abandoned.

However, we recommend that reparations be retained because of the strengths embodied in the statutory due process which Congress wrote into the statute in 1974. The Commission's proposed legislation would, in effect, sever reparations from its statutory underpinnings, and sap its present strength and potential for constructive growth.

Testimony of John J. Conheeney, Chairman
Merrill Lynch Commodities Inc.
Before the Senate Subcommittee on Agriculture, Research and General Legislation

Chairman and Members of the Subcommittee:

My name is John J. Conheeney and I am Chairman of Merrill Lynch Commodities Inc. ("Merrill Lynch"), a wholly owned subsidiary of Merrill Lynch, Pierce, Fenner & Smith, Inc. I am also a member of the Board of Directors of the Chicago Mercantile Exchange, and have previously served on the Board of Governors of the Chicago Board of Trade and the Commodity Exchange, Inc. ("COMEX"). I am currently the Chairman of the Futures Industry Association, Provisional Director of the National Futures Association, and have been in the commodity business for over twenty-nine years.

Merrill Lynch conducts business as a futures commission merchant on behalf of its public customers on all United States contract markets and on all of the world's major commodity exchanges. I am therefore pleased to have this opportunity to offer the views of Merrill Lynch on the reauthorization of the Commodity Futures Trading Commission ("CFTC"), and amendments to the Commodity Exchange Act that have been proposed by the CFTC.

I should first state that Merrill Lynch supports the CFTC's continued role in regulating the commodities futures industry. Although we have occasionally disagreed with particular regulatory actions by the CFTC, it has provided needed protection to the public. It has been our "policeman on the block" and the agency which assures that the nation's commodity markets fulfill their important economic functions. We therefore recommend the re-authorization of the CFTC and the continuation of its jurisdiction over the commodity futures industry.

There are, however, particular aspects of the CFTC's proposed legislation to which we object. For example, the CFTC proposes to impose liability on "controlling persons" for the conduct of those they are asserted to control. This concept, however, would have the undesirable effect of exposing parent companies, their shareholders and their customers to liability arising from the totally separate operations of their commodity subsidiaries. Moreover, such "controlling person" liability is unnecessary because the Commodity Exchange Act already contains broad provisions that impose liability on aiders and abettors of illegal activities, and it specifically imposes liability on principals for the activities of their agents under the doctrine of respondeat superior.

The CFTC also proposes to eliminate the existing practice that allows small firms or individuals that introduce customers to register as agents of the clearing futures commission merchant. The CFTC proposal would effectively remove these firms and individuals from the industry. Such a result would be anti-competitive. It would also conflict with current efforts to deregulate our economy and to eliminate regulatory barriers that unnecessarily hinder small business enterprises.

The CFTC has further proposed the adoption of a so-called "user fee" to pay for all or much of its budget. We believe, however, that this term is a misnomer because it implies that the only persons benefitting from commodity futures markets are direct participants. This is not the case. Although the user fee would be paid by those persons trading commodity futures contracts, they are not the only beneficiaries of CFTC regulation. The American public benefits from the price stability resulting from hedging on commodity exchanges, and it is the American economy that benefits from the price discovery that these markets provide.

The CFTC has also proposed that state and federal regulators pursue an aggressive approach toward the fraudulent activities of persons selling commodity related instruments that are not traded on or subject to the rules of a contract market. We believe that this proposal is necessary, since most enforcement problems are related to such off exchange instruments.

We do object, however, to the imposition of state regulatory authority over contracts traded on foreign exchanges. Commodity trading of necessity transcends national boundaries, because many of the commodities traded on United States markets are "world" commodities that are affected by international as well as domestic factors. Trading on foreign markets is thus integrally related to the price discovery and effective operation of domestic contract markets. In order for these markets to maintain their international scope, however, they cannot operate under inconsistent regulation by the states. Such a situation would severely hinder international businesses that rely on these "world" markets to hedge and to trade. Moreover, because issues involving foreign exchanges touch upon the foreign relations of the United States, an area of exclusively federal concern, those instruments should be regulated solely by the CFTC. Inconsistent state regulation would therefore constitute a serious encroachment on the nation's foreign relations.

Finally, Merrill Lynch believes that the SEC and the CFTC's jurisdiction over the regulation of commodity pools should be clarified to limit the SEC's role solely to the regulation of capital formation activities i.e., the offer and sale of securities to pool participants. The CFTC should be given exclusive jurisdiction over all other activities of commodity pool operators, and it should be stated explicitly that the states are preempted from regulation of pools. This approach would avoid conflicting regulatory requirements that may be imposed by the several states and the SEC.

1. Controlling Persons

The CFTC has proposed amendments to the Commodity Exchange Act that would impose liability upon so called "controlling persons". Specifically, the CFTC proposal would impose liability upon any person who directly or indirectly controls another person violating the Commodity Exchange Act or any of the rules, regulations or orders of the CFTC.

Section 2(a)(1) of the Commodity Exchange Act, however, already contains a specific provision that imposes respondeat superior liability on principals for the acts of their agents. Moreover, Section 13(a) of the Act currently imposes liability on anyone who willfully aids or abets violations of the Act or regulations thereunder. In light of those provisions, there is no need to complicate this statute further by imposing "controlling" person liability.

The courts and the Congress have long recognized the necessity of preserving corporate identity, except in very rare and extreme circumstances. The preservation of this concept is particularly important for commodities firms, which are often owned by a wide variety of enterprises, encompassing so disparate an array of interests as insurance companies, credit card concerns, retail merchandisers, seed companies and grain distributors. Multifaceted financial service firms such as Merrill Lynch also engage in many diverse activities, often bearing little relationship to one another.

To impose liability on a corporate parent for the actions of a commodity subsidiary would only work to the detriment of the industry and the public. For example, the operations of a commodity brokerage firm could expose the security brokerage activities of a parent company, such as Merrill Lynch, to additional risks, thereby endangering the funds or securities of the parent's customers. Merrill Lynch does not believe that this would be a desirable result.

We also note that, while the controlling person concept has been employed in the securities industry for many years, it has resulted in much confusion, a great consumption of time and expensive litigation. Indeed, the circuit courts are even now divided on the issue of whether the respondeat superior doctrine and controlling person liability are mutually exclusive.

This concept additionally gives rise to difficult questions concerning the definition of "control" and the scope and application of defenses identified in such statutes. These and other questions could only be resolved after many years of litigation in our already over-burdened judicial system.

There is also a major distinction between the controlling person provisions of the Securities Exchange Act of 1934 and the current proposal of the CFTC. The Securities Exchange Act thus provides a good faith defense on the part of a controlling person. The CFTC proposal, however, does not specifically provide for such a defense. Its provisions therefore would be particularly harmful if construed to impose liability on an independent corporate entity despite its good faith fulfillment of its responsibilities and duties.

2. Agents

The CFTC has also proposed to amend the Commodity Exchange Act to deemphasize the category of "agent", and to require that persons acting as agents register with the CFTC as associated persons of a futures commission merchant.

In order to fully understand Merrill Lynch's objections to this proposal, it is important to outline the agent's traditional role in the commodity markets. If a commodity brokerage firm is not a member of any of the commodity exchanges and is not registered with the CFTC as a futures commission merchant, it must refer its customers to a futures commission merchant to handle (or clear) the customer's business. In so doing, that "introducing" firm is required by current requirements of the Commodity Exchange Act to register with the CFTC as an "agent" of the clearing futures commission merchant.

In the past, the securities and commodities regulators have recognized the importance of such "introducing" brokers and the desirable functions these brokers perform in providing competition and access for investors to the securities and commodities markets. Because of the importance of this role, and because the introducing broker often does not have the necessary liquid capital to enable it to act as a futures commission merchant or to clear transactions through an exchange, special requirements and exemptions have also been created to allow the introducing broker to function at a substantially lower level of capitalization.

For example, the Securities and Exchange Commission has established exceptions to its net capital rule, allowing introducing brokers to operate under substantially reduced net capital requirements. Moreover, introducing brokers are expressly exempted from the SEC's segregation requirements, as well as from certain of its recordkeeping requirements.

Similarly, the Commodity Exchange Act now allows an "introducing" broker to register as an agent of a futures commission merchant. Under this regulatory structure, the futures commission merchant meets all net capital requirements and other regulatory requirements that would otherwise be a prohibitive cost barrier to the introducing broker.

The CFTC's proposed legislation, however, would eliminate the distinction between introducing brokers and futures commission merchants. Instead, it would require introducing brokers and their employees to become registered as associated persons, i.e., employees, of the futures commission merchant. But it is unlikely that a futures commission merchant will permit this to occur unless the introducing broker contractually surrenders its separate identity, thereby eliminating these small businesses from the market place.

We do not believe that such a result is desirable. Indeed, we believe it conflicts with the provisions of Section 15 of the Commodity Exchange Act, which requires the CFTC to use the least anti-competitive means in achieving its regulatory ends. We also believe that this conflicts with the purposes of the Regulatory Flexibility Act, which requires federal agencies to assure that their regulations do not impact disproportionately upon small businesses, such as introducing brokers.

If the purpose of this proposal is to obtain more effective regulatory control over the small introducing brokers, there are other ways in which the CFTC could accomplish this objective without eliminating these small firms. One method meriting serious consideration is a proposal by a working committee on commodity regulation of members of the American Bar Association to establish a separate category of registration and regulation for "introducing" brokers. We believe that this would allow the CFTC to meet its objective of protecting customers by requiring introducing brokers to meet minimal standards. We also believe that this type of regulatory control could be accomplished under the CFTC's existing rulemaking authority.

3. "User" Fees

The CFTC additionally proposes to impose a user's fee on the transactions of commodity traders. Apparently, the theory behind this proposal is that those benefitting from regulation of commodity futures trading should be required to pay for regulatory costs. If so, this proposal represents a serious misconception of the nature and purpose of commodity regulation.

The so-called user fee would fall most heavily on speculators and hedgers who trade regularly on commodity exchanges, many of whom are Merrill Lynch customers. But they are not the only beneficiaries of the regulatory activities of the CFTC. The American public in general benefits principally from the regulation of commodity futures trading. The commodity exchanges serve a vital role in our economy by allowing producers and users of commodities to hedge their risks, thereby lessening or eliminating violent price swings for articles purchased by the general public. In addition, these markets also establish an important mechanism for the pricing of commodities.

Speculators -- as well as hedgers -- are vital to the effectiveness of these markets. It is the speculator who absorbs the risk that the hedgers displace, and it is the speculator who contributes liquidity to the markets and thereby allows hedgers to hedge. Without both speculators and hedgers, there simply can be no futures markets, and our economy would suffer.

Because speculators and hedgers are frequent traders, the "user" fee will have a cumulative effect that will significantly increase the cost of their business. This would discourage these traders from using these markets, and would reduce their effectiveness. Such a result would clearly be undesirable. We therefore urge that this fee not be adopted.

We also believe that the imposition of these additional costs directly on industry participants will have an adverse effect on current efforts to reduce the CFTC's regulatory costs through the National Futures Association. Members of the industry will be very reluctant to fund that Association and the CFTC as well.

4. CFTC Jurisdictional Issues

Finally, the CFTC proposes to make explicit the coverage of the securities laws to the capital formation activities of commodity pools. We do not object to this, but the SEC and the CFTC have stated that they may also seek to require commodity pools and persons managing them to comply with the requirements of the Investment Advisers Act and the Investment Company Act, as well as CFTC requirements. We believe that such duplicative regulation should be avoided. The Commodity Exchange Act should be amended to make clear, contrary to the suggestion of the SEC and CFTC, that pools, and their advisers and managers, which invest solely in commodity futures contracts, should not be subject to the provisions of the Investment Company Act and Investment Advisers Act. To do otherwise would only subject commodity pools, their advisers and managers to conflicting and inconsistent regulations and unnecessarily increase the costs of commodity pool activities, to the detriment of the public.

We also oppose any regulatory jurisdiction by the states over commodity pools. Such activities are fully and adequately regulated by the CFTC, and overlapping state jurisdiction can lead only to conflicting and burdensome regulatory requirements. Indeed, two states have enacted regulations prohibiting the offering of SEC-registered pools.

We do support the CFTC proposal that would authorize state and federal regulatory authorities to pursue persons trading in off exchange instruments. It is those instruments that have been involved in the vast majority of the problems encountered in the commodities industry, and the "open season" proposal will assure effective regulation. We believe, however, that the states should not be allowed to regulate commodity contracts traded on foreign exchanges. This involves an area of foreign relations, an exclusively federal concern, and should be within the exclusive jurisdiction of the CFTC.

TESTIMONY OF HAROLD J. HEINOLD
BEFORE THE
SUBCOMMITTEE ON AGRICULTURAL RESEARCH &
GENERAL LEGISLATION
COMMITTEE ON AGRICULTURE NUTRITION & FORESTRY
UNITED STATES SENATE
MARCH 10, 1982

My name is Harold J. Heinold of Kouts, Indiana. I am Chairman of Heinold Commodities, Inc. and Heinold Hog Markets, which are independent subsidiaries of DEKALB AgResearch, Inc. With me is Lawrence Hunt of the Chicago law firm of Sidley & Austin, our counsel.

Heinold Commodities was started by me in 1967, and is now one of the largest commodity futures brokers in the country. Its customers include farm and commercial hedgers and speculators. It has net capital of about $90 million, and has more than 100 offices throughout the nation. Heinold Hog Markets, which I began in 1950, has over 100 hog and cattle markets in nine states, mostly in the midwest. Its business is to market hogs and cattle for farmers. Because farmers often do not want to get involved with futures contracts and margin calls, we provide the farmers with price protection by contracting to buy their livestock at a fixed price in the future. We in turn protect ourselves by hedging on the futures markets.

We are filing a written statement explaining our views on a number of the issues now before this Committee. In general, we support the bill entitled Futures Trading Regulatory Improvements Act of 1982, which was developed by a broad group of people in the futures industry. Today, I would like to highlight three areas for the Committee Agricultural Options, Speculative Limits, and SEC Jurisdiction.

1. Agricultural Options

I feel very strongly that the current ban on agricultural options should be lifted. This ban was imposed before the CFTC was in existence, and was a reaction to numerous defaults which occurred when individuals granted options and then could not back them up. With the established commodity exchanges to control and regulate options, and with the CFTC to oversee the exchanges, there is no reason to continue the ban.

Futures markets have given the farmer price protection on his livestock and grains. However, because of past steep market movements requiring large margin calls, many farmers distrust the futures markets. Bankers hesitate to loan to farmers who are not protected in the futures markets, but bankers also are afraid of drastic market movements that would lead to huge margin calls. As a result, farmers often cannot get loans to finance hedging.

There is another problem farmers have with the futures markets. A farmer who hedges on the futures markets can avoid downward market movements in the value of his livestock and crops, but he will also give up the chance to benefit from upward movements.

Agricultural options would give farmers a much better way to protect themselves. With options, a farmer could insure against the effects of downward market movements, but at the same time he could benefit from upward movements.

Options would be like an insurance policy, and the premium paid for an option would be like an insurance premium. If the markets were to move in the farmer's favor, the option would not be needed and it would simply expire. If the market were to move against the farmer, he could exercise his option to sell his crop at the option price.

Let me give you an example. First the use of futures contracts -- if a farmer has cattle that will be ready for market in December, he can sell December futures and lock in a sale price - say 50 cents per pound. Then no matter which way the market goes, he will get the 50 cents per pound price.

Now the use of options -- if options to sell at 50 cents per pound in December were available, the farmer could buy this option at a premium - say 3 cents per pound. If the market were to go up to 60 cents per pound he would not exercise his option and he could benefit from the higher market price. If the market were to go below 50 cents per pound, he could exercise his option to sell at 50 cents. Taking into account the 3 cents he has paid for the option, he would get a net price of 47 cents per pound. In this way, an option would be like an insurance policy with a deductible feature.

Options could also be used to insure against higher feed costs. For example, if the farmer will need corn to feed his livestock in December, he could buy an option to purchase corn at a set price in December - say $2.95 per bushel, at a premium of - say 15 cents per bushel. If the corn market goes down, he can purchase his corn at the lower market price. If the market goes above $2.95, he can buy the corn at $2.95. Taking into account his 15 cent premium, his actual cost will be $3.10.

We all buy insurance to protect ourselves against disasters of one sort or another. The farmer should also be able to do this and the agricultural option would let him do it. By giving this price protection to the farmer, the option would also reduce the need for governmental price supports.

We understand that the CFTC does not oppose the lifting of the ban on options if there is enough interest in the agricultural community. We believe the interest does exist, and that options would give the farmers a way to protect and insure themselves that they do not have now.

2. Speculative Limits

The bill that we support asks Congress for reform of speculative limits, which are limits placed on the number of futures contracts that any one person may own.

We believe that efficient futures markets require speculators. For each hedge dollar in the markets, several speculative dollars are necessary to give the markets enough liquidity to function properly.

The speculative limits that the CFTC has set in the past have been far too low. For example, in 1938, the limits on wheat were set at 2,000,000 bushels, and this figure has only been increased once - to 3,000,000 bushels in 1976. The increase in volume in the markets has been far greater during this time, so that limits are relatively far lower now than they were in 1938.

The low speculative limits have prevented the markets from being as liquid as they might be if the limits were higher. Also, the low limits have restricted the growth of commodity pools. These pools allow the small investor to pool his capital with that of other small investors and obtain professional management. Small investors benefit from having this chance to participate in the markets, and the markets themselves benefit from the increased liquidity.

The bill we support would amend the Act to require the CFTC to justify any limits in terms of factors such as market volume and open interest, so that limits would be set at realistic 1980's levels and not at low 1930's levels. This bill would also require that the exchanges, which are closest to the markets, set limits in the first instance. The Congress should adopt these much-needed reforms.

3. SEC Jurisdiction

I believe the farmers of this country will be greatly disadvantaged if the Congress approves the CFTC-SEC jurisdictional agreement. We see this agreement as being the first step toward a consolidation of the CFTC and SEC, which would greatly reduce government attention to the needs of agriculture.

It is important for the agricultural community to have an agency and Congressional oversight committees that are sensitive to the risk-shifting needs of the farmers. The CFTC had its origin in the Department of Agriculture and the oversight committees in the House and Senate have been those whose primary concern is agriculture.

The division of authority between the CFTC and SEC in the past has been based on the difference between riskshifting and capital formation. The CFTC-SEC agreement does not follow this principle. For example, foreign currency options, which are risk-shifting instruments, would be regulated by both agencies under their proposal. We are concerned that once the line has been crossed by the SEC, the end result would be a single agency to regulate both investment and risk-shifting. The attention given by government to the risk-shifting needs of the farmers would be greatly reduced.

We ask that the Congress not adopt the CFTC-SEC agreement, but instead reserve the matter for further study. Many of the jurisdictional issues are now before the courts, and court decisions in this area may make action by Congress unnecessary.

We appreciate this chance to express our views to this Committee, and my counsel and I will be happy to answer any questions you may have.

APPENDIX TO THE TESTIMONY OF HAROLD J. HEINOLD BEFORE THE SUBCOMMITTEE ON AGRICULTURAL RESEARCH AND GENERAL LEGISLATION, COMMITTEE ON AGRICULTURE NUTRITION AND FORESTRY, UNITED STATES SENATE, MARCH 10, 1982

The 1982 Reauthorization Hearings on the Commodity Exchange Act have prompted many groups to advocate revisions to the Act. Some of the proposed revisions are minor and are intended to eliminate some of the inefficiencies in the operation and enforcement of the Act. Some of the proposals, however, recommend major changes in the Act which would produce the anomalous result of substantially increasing government regulation of the commodity futures industry and duplicating government functions at the same time Congress has assumed the herculean task of decreasing government regulation of private industry and reducing the cost of government. For this reason, these proposals require careful scrutiny and an assessment of whether they would, if enacted in law, improve the enforcement of the Act or would merely increase government regulation and government interference with the operation of free market forces in the commodity futures industry. The major proposals which require this scrutiny include giving the States jurisdiction to regulate the commodity futures industry, imposing liability on "controlling persons" for the actions of low-level employees, increasing the supervisory responsibilities of futures commission merchants over independent brokers and charging "user fees" for participation in the commodity futures market.

1. Controlling Person Liability

The CFTC is proposing an amendment to the Act that would provide for "controlling person" liability. Under this provision, any person who directly or indirectly controls another person who violates the Act could be held liable for the violation. In order to defend successfully against liability in this situation, the controlling person would have to show that he did not know, or in the exercise of reasonable care did not have reason to know, of the facts constituting the violation.

The apparent objective of this amendment is to give the CFTC authority to enforce the Act against persons in charge of fraudulent commodity operations where the actual rule violations are committed by lower level employees. Because the CFTC's proposal would have serious consequences with respect to reputable firms without significantly increasing the Commission's enforcement capability as to the disreputable firms and persons it is intended to reach, the proposal will have no social benefit to justify such increased regulation and should, therefore, not be adopted.

The controlling person provision would have several undesirable effects on commodity brokerage firms, the vast majority of which regards compliance matters seriously. First, in addition to imposing liability on executive officers of reputable firms such as Heinold for the activities of low-level employees with whom they have no direct contact, the CFTC's "controlling person" proposal would extend potential liability to the executives of parent companies of brokerage firms; e.g., DEKALB AgResearch Inc., which is Heinold's parent, and DEKALB's officers, might be held liable for a violation by a Heinold employee, even though DEKALB is not engaged in the futures brokerage business.* Second, the additional compliance procedures necessitated by the CFTC's proposal will of course increase the cost of doing business and be borne ultimately by the customers. Finally, the CFTC's proposed controlling person provision may actually have the effect of decreasing rather then increasing supervision. Because controlling person liability is based upon knowledge or reason to know of facts constituting violations, commodity brokerage firms may design procedures to minimize controlling person liability by channeling information so as to remove management from the information flow that might make them liable. Supervisors would understandably be reluctant to report or take action on rule violations they discover since they would in effect be prosecuting themselves. Rather than increasing supervision of low-level brokers, the ironic result of the controlling person provision would be, in addition to increasing costs, to reduce the flow of information to management, and discourage vigorous in-house compliance efforts.

Moreover, the controlling person provision would provide no enforcement benefits to justify such increased regulation, even with respect to the disreputable persons and firms it is intended to reach. Under the present language of the Act, any person who participates in a violation of the Act by another can be held liable as an aider and abettor.** Hence, the very persons the CFTC seeks to prosecute, namely, those who induce others to violate the Act, would be liable under the Act as it now stands. In addition, the Act's agency provision now in effect makes firms liable for the acts of their employees and agents, so that, for example, any customer with a reparations claim against an employee of a brokerage firm can look to that firm to satisfy any damage award. Heinold, which has a net capital of approximately $90 million, has more than adequate capital to satisfy any foreseeable damage award. Heinold believes, therefore, that the present provisions of the Act are fully adequate to protect the public and to give the CFTC the means to rid the industry of unscrupulous operators.

---

* Although the CFTC could exercise prosecutorial discretion to enforce the controlling person provision only in those few cases where it was intended to be applied, the proposed amendment would not limit the Commission's discretion in this area, and therefore would not insure that enforcement would be so limited. Perhaps more significantly, the controlling person provision would be available to private parties in reparations proceedings; such private parties would not be likely to exercise any restraint in naming officers and supervisors as respondents, and would likely name these persons as a matter of routine.

** In that respect, the controlling person provision in the securities laws is more akin to the aiding and abetting provision of the Commodity Exchange Act than to the CFTC's proposed controlling person provision. The aiding and abetting provisions in the Commodity Exchange Act and the controlling person provision in the securities law both require participation in a violation; the CFTC's proposal would impose liability for merely failing to know about the conduct constituting the violation.

2. Independent Brokers

The CFTC has proposed that the Act require independent brokers to be registered as associated persons of the futures commission merchants (FCMs) who clear their customers' trades and safekeep their customers' funds. These independent brokers, now considered "agents" of FCMs, are not presently required to register with the CFTC but are merely listed as agents on the registration application of the clearing FCM. Consequently, even though they deal with their customers as FCMs do, with the exception of clearing customers' trades and holding customers' funds, the independent brokers are not subject to the fitness, financial, and additional regulatory requirements that apply to other persons who deal with the public in futures transactions.

We join with CFTC in advocating the elimination of the agent category from the Act. We differ, however on what category should take its place. The CFTC proposes that all persons now considered agents be required to register as associated persons of an FCM. Currently, only persons who are officers, partners, or employees of an FCM are required to be registered as associated persons. We propose a new category of registrant, to be known as "introducing broker," to replace the agent category.

The CFTC's proposal assumes that independent brokers are acting subject to the control and supervision of the clearing FCM. That assumption is erroneous. Independent brokers are in effect customers of the clearing FCM. They solicit and accept orders for their own customers and use the services of an FCM only for clearing, recordkeeping, and funds safekeeping. They frequently change from one clearing FCM to another just as a customer might change from one broker to another. Under these circumstances, the clearing FCM does not and cannot effectively control the independent broker's activities, and it would be unwarranted and misleading to use a registration category, such as that proposed by the CFTC, which suggests otherwise.

Heinold supports the proposal that the agent be replaced by a new registration category known as "introducing broker," which would be clearly defined to include those persons who solicit or accept futures orders, but do not handle customer funds. Introducing brokers would be required to register directly with the CFTC, and would be required to provide the CFTC with the same type of detailed information now provided by other applicants for registration. With direct registration, the CFTC or National Futures Association ("NFA") would be able to establish and review qualifications, and could disapprove, suspend, or revoke registration as appropriate. In addition, the CFTC or NFA could establish financial and performance standards for introducing brokers, analogous to those presently in effect for FCMs. Compliance with these standards could be monitored, and enforcement action could be taken when necessary.

We believe that the separate introducing broker category would serve the public interest better than the CFTC's associated person proposal. Under the CFTC's proposal, independent brokers would be subject only to the requirements imposed on associated persons. They would not be required to satisfy any independent financial standards and would for the most part be regulated only indirectly, i.e., through the FCM. The introducing broker category we propose would make independent brokers directly and independently accountable to the Commission, the NFA, and the public, and would thus require from them a higher degree of professionalism, competence, and responsibility.

2. State Jurisdiction

Since 1975, the CFTC has had exclusive jurisdiction over the futures industry. To preserve the CFTC's jurisdiction and to avoid unnecessary duplication in the regulation of the futures industry, the Commodity Exchange Act has prohibited the States and other federal agencies from encroaching upon or interfering with the CFTC's exclusive jurisdiction. The States have now proposed, as they did in 1974 and again in 1978, that they be given jurisdiction to regulate the futures industry together with the CFTC.

If adopted, this proposal would constitute a complete reversal of past Congressional policy. When the CFTC was established by Congress in 1974, the CFTC was granted exclusive regulatory jurisdiction, and the legislative history stressed that state regulation was preempted. In the 1978 Reauthorization Hearings, the States attempted to amend the Act to permit enactment and enforcement of state statutes identical to the antifraud provisions of the Commodity Exchange Act. Congress rejected the States' proposal, but adopted section 6d, which gives the States the right to enforce the Commodity Exchange Act in federal court, subject to the right of the CFTC to intervene to assure uniformity.

Prior to the grant of exclusive jurisdiction to the CFTC in 1974, the 50 States, Puerto Rico, and the District of Columbia each had a securities administrator who asserted varying degrees of regulatory authority over futures contracts. Among the States, there was a substantial difference of opinion as to whether futures contracts or discretionary accounts were "securities" and subject to regulation by the States under their Blue Sky laws. Some security commissions regarded futures contracts as securities and some did not. Some regarded discretionary accounts as securities; others would examine each discretionary account agreement to determine whether it constituted a security. Some commissions would waive security law requirements which were clearly inapplicable to the commodity brokerage industry, while others would refuse to do so on purely arbitrary grounds. Most state security commissioners had no experience with commodity futures and would often make uninformed decisions on how state security laws applied to commodity futures contracts. This regulatory chaos with duplicative and conflicting requirements would inevitably recur if the States were granted regulatory authority.

Exclusive federal regulation of the futures industry has resulted in a single set of uniform regulatory standards to govern the industry. The CFTC has authority to regulate the futures industry directly, and also to supervise regulation by authorized commodity exchanges and registered futures associations. Subject to CFTC oversight to assure uniformity, the exchanges have authority to regulate their own markets, and the newly formed National Futures Association ("NFA") will have authority to regulate retail practices in the industry.

We urge Congress to reject the States' proposal and to reaffirm the CFTC's exclusive jurisdiction over commodity futures in the legislative history of the 1982 Reauthorization Hearings. We believe that the latter action is necessary because, despite Congress' intent in amending the Commodity Exchange Act in 1974 and 1978 to preempt state law, some courts have permitted civil litigants to assert claims against FCMs under state law. A clear expression of Congressional intent in the legislative history now would reduce the likelihood that commodity brokerage firms would be subjected to different and inconsistent state standards under state consumer protection statutes and other state laws.

3. User Fees

The CFTC proposes to fund virtually 100% of its expanded budget by a system of user fees. The proposed fee would be payable on futures trades and collected by the exchanges on a per trade basis.

We believe that the user fee system as proposed by the CFTC will undermine the effectiveness of the NFA. NFA which is about to be financed by the futures industry, should be given the opportunity to demonstrate that it will be an efficient regulator of the futures industry which will reduce the regulatory burden of the CFTC and concomitantly enable the CFTC to reduce its budget. If the user fee system is established, the funding for the NFA which will come from the futures industry may be jeopardized, especially if the user fee is high.

Finally, we believe that the user fee proposal is premised on a false assumption. The user fee proposal assumes that only futures market participants benefit from efficient futures markets and that, therefore, only they should fund government regulation of those markets. However, it should be readily apparent that efficient commodity futures markets benefit all consumers of commodities and our economy as a whole, not just the traders who would pay the fee.

STATEMENT OF

THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

By
MICHAEL UNGER
Director, Massachusetts Securities Division

ORESTES J. MIHALY
Assistant Attorney General in Charge
New York Bureau of Investor Protection and Securities

and

K. HOUSTON MATNEY
Maryland Securities Commissioner

Submitted to

The Subcommittee on Agricultural Research & General Development
of the
Senate Agriculture Committee
on
March 10, 1982

Members of the Committee, we welcome this opportunity to present the views of the North American Securities Adminstrators Association, Inc., ("NASAA"), and of each of the members of this panel as the securities administrator of his respective state, on the inadequate performance of the Commodities Futures Trading Commission ("CFTC") in combatting commodities fraud and the related inability of our members to combat such fraud as a result of the preemption of state jurisdiction in Section 2 of the Commodities Exchange Act ("CEA").

NASAA is an association of state and provincial securities administrators from the United States, Canada and Mexico which, since 1918, has worked for investor protection. State securities commissioners are charged with promoting investor protection and regulating the securities markets in their respective jurisdictions. NASAA's activities involve cooperative efforts among its membership as well as with other law enforcement officials and certain federal agencies.

In this testimony we will address (i) the inability of the CFTC to combat commodities fraud through administration of the CEA; (ii) the preemption of a basic state police power in Section 2 of the CEA; (iii) the difficult enforcement problems faced by state securities administrators in attempting to combat commodities fraud; and (iv) the legislation proposed by the CFTC and NASAA's own legislative proposals.

The CFTC is charged with regulating the commodities and futures market, which includes maintaining a uniform regulatory system, to assure an orderly and competitive system of commerce. Investor protection comes within that charge, but policing the sales practices of agents soliciting public funds in commodities related transactions is not a primary mandate of the CFTC. In 1974, Congress granted exclusive jurisdiction to the CFTC in Section 2 of the CEA, thereby preempting federal securities laws and state commodities and securities laws. The basis for this grant of exclusive jurisdiction was the national, and often international, scope and effect of the futures markets and the existence of non-uniform state regulation. The futures exchanges were deemed to be an integral part of the national economy and the contracts traded on such exchanges had to be uniform in order to be competitive.

Pursuant to its mandate, the CFTC has concentrated its efforts on developing an efficient national market system, i.e., a concentration on the hedging and speculative aspects of the futures markets, rather than on monitoring the investment by the general public in the futures markets. This public investment aspect of the futures markets has grown in substantial proportion since 1974, especially in the form of "boiler rooms" which specialize in the mass marketing of commodity-related instruments to unsophisticated persons who are unaware of the risks and potential losses inherent in such investments or the persuasive pressures being placed on them. This type of fraudulent activity in the futures markets impairs the integrity of the system and should not be protected by the granting of exclusive jurisdiction to create uniform regulation of the futures markets. The thievery and deception flourishing in these boiler rooms is that type of activity more effectively dealt with by local law enforcement officials, in particular, the state securities commissioners.

The grant of exclusive jurisdiction to the CFTC and the concurrent preemption of the basic police power of states to protect their citizens from fraudulent activity constitutes a major failure of government in its establishment of regulation to protect investors. The CFTC has been incapable of curtailing the pervasive national commodities frauds alone. It is time for Congress to reconsider its 1974 decision to grant exclusive jurisdiction to the CFTC and return jurisdiction to the states.

Part of this failure to protect investors is a result of the methods utilized by the CFTC's Enforcement Division in combatting frauds, which does not emphasize criminal prosecution. The 1980 CFTC Annual Report reports that the Enforcement Division opened 777 and closed 689 investigative matters during the year. It also initiated 36 administrative proceedings and 19 injunctive actions of which a total of 30 actions were closed. The high number of investigative cases opened and closed gives no indication as to what matters were actually under investigation, nor does it point out that many closed investigative actions go into the backlogged hearing process where a resolution is months or years away.

The Annual Report mentions the initiation of 19 injunctive actions. Of those 19 actions, 15 are footnoted in the Report, but, of those 15 actions, 12 were brought against firms which had gone out of business before the CFTC initiated almost meaningless injunctive actions.1/ Injunctive actions filed against thieves, crooks and con men in federal courts are an ineffective response to fraud. These thieves, and the record supports this statement, usually set up a new corporation and continue their fraudulent operations in some other deferred delivery contract boiler room, while their lawyers drag out lawsuits by filing numerous dilatory motions.2/

The CFTC views this record of injunctive actions as demonstrating an aggressive and public-spirited investor protection program, but the members of NASAA view these injunctive actions as being too little, too late. State securities administrators are frustrated by this meaningless and ineffectve injunctive program while their constituents' savings are daily fed into boiler room fires on the altar of exclusive jurisdiction.

1/ The caption for each of these matters would be CFTC V.: V. Currency Specialists, Inc.; v. Michael Burke; v. First United Investment Corp.; v. Jefferson National Investment Corp.; v. Commercial Petrolea Internacional; v. R&M Precious Metals, Inc.; v. CoPetro Marketing Group, Inc.; v. Sterling Capital Co.; v. Annapolis Funding Company; v. Ashton & St. John's, Inc.; v. Auric Equity Corp.; v. John J. Buterin; v. Trending Cycles for Commodities; v. Incomoco, Inc.; and v. Commodities America Corporation.

2/ See Texas Cases involving United Petroleum Exchange Corporation and Robert Greenberg, and Sami Eisbart and National Coal Exchange.

Preemption of state law in the commodities fraud area does not serve either the interests of legitimate commodities firms or the investing public. To date, the only persons to benefit from the exclusive nature of CFTC's jurisdiction are thieves, swindlers and boiler room operators. The national interest, commerce and government have been poorly served by the blind extension of exclusive jurisdiction to areas where there is no pressing national interest in uniformity or where concentrations of resources are best left outside of Washington, D.C. By what reasoning is it in the interest of the futures business for state authorities to be discouraged from chasing criminals and thieves who claim to be in the future as business when in fact they are not? Is there a genuine national purpose to be served by impeding local prosecutions of fraud and wrongdoings which incidentally touch upon commodities-related transactions under CFTC jurisdiction?

The scams and rip-off schemes continue unabated. Every year since the creation of CFTC, our country has experienced a major scandal involving commodity-related investments. Each passing year has witnessed an unchecked migration of thieves, con artists and swindlers to the commodities investment area. Beginning with the infamous Lloyd, Carr and Company frauds in 1976 and 1977, followed by commodity options, continuing through silver and gold bullion sales, to deferred delivery contracts for crude oil and coal, and now with commodity pool frauds, boiler room operators have looted untold sums of money from our nation's citizens. If states are to give over their fundamental police powers to a unified federal system of regulation and enforcement, is it too much to ask that the federal system at least be able to protect the citizens of those preempted states?

The CFTC has criticized its own inability to regulate investment scams disguised as legitimate commodity firms. As Chairman Johnson said on September 25, 1981, "our small agency simply cannot act as a national fraud strike force."[3] His predecessor, Commissioner James M. Stone, shares the realization that CFTC has proven incapable of policing those markets and transactions over which it has exclusive jurisdiction.[4] The CFTC's inability to provide investor protection is almost universally recognized by those enforcement-minded attorneys who have traveled quickly through the revolving door of CFTC's Enforcement Division.[5]

These public statements of CFTC's failures come as no news to state administrators or the many victims of unscrupulous salesmen of commodities-related investments. What does come as infuriating news is that CFTC, in spite of its many public admissions of inability to protect the unwary from the unscrupulous, continues its threats to file suit against those state administrators who seek the use of securities laws to attack boiler rooms. We are all aware that CFTC did intervene as amicus curiae challenging Arkansas' attempts to protect investors from commodity frauds.[6] The CFTC acted similarly to vacate an injunction obtained by the New York Attorney General's Office against a fraudulent commodities operator in New York. In 1981, in response to an inquiry from the Tennessee securities administrator concerned with CFTC non-action on cases involving Memphis boiler rooms in deferred delivery contracts in coal, CFTC officials admitted that there would be "a high risk of CFTC intervention" if Tennessee attempted to resolve the Memphis boiler room problem under Tennessee securities laws.

---

[3] BNA Securities L. Rep. No. 622 (September 30, 1981), p.E-3.

[4] BNA Securities L. Rep. No. 630 (November 25, 1981), pps. E-1, E-2.

[5] The Business Week, July 6, 1981, "A Commodities Scam Rocks A Regulator", pps. 25-26.

[6] International Trading Ltd. v. Bell, 556 S.W. 2d 420 (Ark. 1977).

The state securities administrators became aware of the failure of the CFTC to act as a national police force soon after the grant of exclusive jurisdiction in 1974. With offices located only in Washington, D.C.; Chicago, Illinois; New York, New York; Kansas City, Missouri; Minneapolis, Minnesota and San Francisco, California, the CFTC is unable to adequately combat commodities frauds nationwide. In 1978, NASAA held hearings on commodities frauds and prepared a report of its findings. This report, which has been made available to the staff of this Committee, documents a state of affairs not unlike the present -- the inability of the CFTC to adequately protect investors and the need for an end to total exclusive jurisdiction. The last four years have acted as a continuation of that state of affairs and as further proof for the implementation of the conclusions drawn in that report which are similar to NASAA's present legislative proposals and constitute a reinvestment of jurisdiction of the states. The need for uniformity and stability in the national markets has little, if any, importance in the area of law enforcement where the primary goal is the protection of investors. In fact, the stability of the futures markets is threatened by the surging growth in the number of fraudulent commodities operators.

For 200 years, our nation had a federal system of government as opposed to a central government. Dual sovereignty was intended to buttress the system of checks and balances and provide, through the states, a level of government that was closer to the people while far enough away to avoid being captured by parochial interests. Today, the states and their citizens stand in danger of being eclipsed by the federal government they created. The past 50 years have witnessed, until quite recently, an increase in the concentration of financial and policy making responsibilities at the federal level. Erosion of the states' role, especially in the areas of consumer and investor protection, threatens to undermine a truly federal system of government.

These past few decades of governmental policy have reached their crowning achievement in the creation and maintenance of the CFTC's exclusive regulatory and enforcement powers. Nowhere in the entire federal system is there to be found greater evidence for the statement that all wisdom does not reside on the banks of the Potomac.

Conferring upon CFTC additional resources to fight fraudulent operators in the commodities investments is no answer to the present grave threats to investor protection. The structure and mandates of the CFTC are such that commodities frauds would still not be checked. Why else do those of us in state regulation witness the daily migration of thieves and con men to commodities investments? Why else has commodity investment become synonymous with fraud? In this era of federal deregulation and the new federalism, it is not the time to pour additional resources into a federal agency where the states securities administrators have the mechanism and incentive to act as a police force over commodities frauds. Authorizing additional resources to the CFTC's injunction program will not effectively curtail securities fraud. Commodities thieves are best defeated through prosecution in criminal trials in state courts in the state where their victims reside. The history of state securities enforcement has proven a very effective deterrent against fraudulent investment scams. Those sanctions must to be employed in the commodities fraud area.

Similarly, the solution to combatting commodities frauds, particularly as to off-exchange trading, does not lie with the National Futures Association ("NFA"), the self-regulatory organization ("SRO") for the commodity futures industry, and more specifically, floor commission merchants. While the existence of an SRO may provide much needed support to the efforts of a greatly understaffed CFTC, it would be extremely naive for anyone to assume that the NFA will be able to have any significant impact upon the massive off-exchange fraud that currently afflicts the nation, and, in fact, that would not be the role of the NFA. Its responsiblity will be to provide self-regulation over entities and individuals who submit themselves to the jurisdication of the CFTC via the registration process. In the securities realm, state securities administrators play an integral role in combatting fraud notwithstanding the existence of the National Association of Securities Dealers, Inc. ("NASD").

The overwhelming majority of such registrants are not the source of fraudulent activity. Rather, it is a distinct minority of registered firms and individuals who cause the greatest threat to the integrity of commodities trading and the public. A review of the CFTC's weekly bulletin will reveal the names of firms who time and time again appear as respondents in reparation proceedings brought by unhappy and cheated investors. We cannot, in good faith, assume that these firms, who push their operations and marketing to the fine edge of legitimacy, will be more responsive to an SRO than they are to the CFTC.

In considering the efficacy of an SRO as a substitute or supplement for strong state and federal regulation in the marketing end of commodities transactions we must be mindful that we are dealing with an industry that has consistently opposed almost every suggestion, idea or rule proposal that would benefit the public investor. For example, the suggestion that there be an investor suitability standard — a standard long employed and accepted in the securities industry which provides an excellent self-policing mechanism for broker-dealer firms to guard against over-zealous sales personnel — was vociferously attacked by industry and rejected by the CFTC. The major, if not only, impetus for the creation of a suitability standard lies in the protection of unsophisticated investors. There is no great regulatory burden in a rule which requires a commodities salesman to ascertain that a particular investment is appropriate for his client. The volatility and highly speculative nature of commodities trading compels the conclusion that only certain investors are candidates for such investments. If those who trade in securities, certainly a more conservative investing medium than commodities, must adhere to a suitability standard, why shouldn't commodities traders. The commodities industry's track record to date does not evidence a desire to openly advocate and push for strong investor protection standards in the marketing of commodities products.

It is difficult to assess the role the NFA will play in regulating the commodities industry. Since it is only recently formed, the NFA is years away from becoming a significant regulatory force — assuming of course, that the CFTC and industry work to make it so. During the interim, the growth of the commodities trading industry will continue, and exotic and innovative products will keep appearing in the marketplace, as the investing public continues its search for relief from inflation. Without swiftly reinstating state jurisdiction, investors will be prey to thieves who take advantage of the CFTC's transfer of responsibility to an SRO not at its optimal operational level.

The CFTC's efforts at investor protection to date can only be characterized as a failure, and it is unreasonable to expect that an SRO controlled by industry and overseen by that same agency will do any better. Congress will do a great service to investors of this nation by providing adequate mechanisms within the federal regulatory scheme that enable state securities administrators to police the sales end of the commodities marketplace. Any reliance upon that task being properly undertaken by an SRO would be misplaced.

Despite the preemptive language in the CEA, state securities commissioners continue to be viewed by their constituents as the authorities to whom to report and expect action in connection with commodities frauds. The "horror stories" documented in these complaints are evidence that these boiler room operators do not deal with experienced futures hedgers or speculators, but rather the inexperienced investor who seeks to invest his life's savings. The states securities commissioners often take action on these complaints, notwithstanding the exclusive jurisdiction of the CFTC. We have made available to the staff of the Committee copies of complaint letters received by state securities administrators, affidavits obtained during the course of investigation and extracts from depositions or administrative hearings which eloquently portray the story heard time after time in recent years.

These "horror stories" of investor experiences, all of which are related in full, and summarized, in the Exhibits forwarded to the Committee and reflect the techniques utilized by boiler room operators. From Georgia, Richard A. Çard tells the story of his loss of $11,000 to National Coal Exchange in deferred delivery contracts. In Massachusetts, in proceedings against PMA Commodities, John Eyberg describes, as no lawyer or regulator could ever effectively articulate, his experiences with so called "Limited Risk Forward Contracts", involving a $4,000 investment. From Wisconsin, A. Stephen Jorgenson and Gerald V. Vande Hey describe their experiences with the L. B. Daniels Agency. From Maryland comes the story of "John Doe" who sufferred a $13,000 loss in coal contracts. Mr. Doe has requested anonymity in order to spare himself any further embarrassment, as his previous on-the-record cooperation with law enforcement officials has already resulted in substantial commitment of his time, marital discord, and public embarrassment in addition to the financial loss.

Certain common elements emerge from each of these stories regardless of the nature of the underlying investment. Whether the pitch is for coal, gold or silver, the success of the fraud depends upon:

(1) The hardsell by repeated telephone solicitations;

(2) The purported relationship of the selling company to some "reputable" exchange or other organization which will always remain happy to verify the legitimacy of the caller;

(3) The use of misrepresentations over the phone which are invariably contradicted by the documents supplied after the investor's money has been received;

(4) Insistence upon the use of wired funds, thereby giving the investor little time to reconsider the purchase;

(5) The apparent legitimacy of the actual written contract supplied which has been carefully drafted so as to involve neither the sale of a regulated commodity nor a security if the investment was, in fact, limited to the program described in the "contract";

(6) The use of a "maturity date" generally a year later so as to delay the time in which the investor will realize he has been taken.

Perhaps the most unfortunate aspect of these investor experiences is not the individual's financial loss but rather the devastating impact of these losses in the aggregate nationwide. While a review of countless "horror stories" across the country would probably yield a quantitative measure of the damage already done, how does one quantify the future loss to our legitimate financial marketplaces when these victims become so skeptical as to avoid future investments in economically productive activities?

We have also made available to the Committee eleven states' responses to Senator William B. Roth's letter requesting information on the level of commodities fraud since 1978, specific attempts by states to combat this fraud by civil or criminal action, the ineffectiveness of joint state-federal actions and Section 6d parents patrie suits and the ability to obtain necessary information from the CFTC for enforcement purposes.

These responses address and reflect many of the concerns contained in this testimony. They document an increase in commodities frauds encurrent with the preemption of state jurisdiction including the appearance of repeat violators. The states have brought few, if any, civil or criminal actions for fear of CFTC intervention. The states have attempted to combat commodities fraud, notwithstanding preemption. They conduct their own investigations, including cooperative enforcement efforts through NASAA. Many states have attempted to deal with commodities fraud through the issuance of cease and desist orders in administrative proceedings. Some states have utilized publicity to combat commodities fraud through press releases, speeches, public hearings and commodities "hot lines". Certain securities administrators reflect the frustration of their citizens who are told that the administrator is preempted from acting against fraudulent activity and their own frustration at the CFTC's vigor in its claim of exclusive jurisdiction while investors continue to be robbed.

Certain responses addressed the difficulty the states confront in obtaining enforcement information from the CFTC. In particular, if a state or an investor wishes to obtain information on a licensed or registered person, the CFTC generally gives no information other than the fact that such person is or is not registered or licensed, notwithstanding such person's past violations. In addition, certain states, on receiving registration or licensing applications from the CFTC, find such applications to be misleading or incomplete, evidencing inadequate review in the registration process.

Certain responses concur in the conclusions drawn herein regarding the ineffectiveness of Section 6(d) and the inability of an SRO to adequately meet the challenge of commodities frauds. The states' responses reflect their belief that jurisdiction must be returned to the states.

In the 1978 amendments to the CEA, the states were granted, in new Section 6d, the limited authority to file civil actions in federal courts to enjoin violations of the CEA and of CFTC regulations. This authority has proven too limited to stop fraudulent commodity schemes which have come to the attention of state officials, and state attempts to enforce the CEA in federal courts in cooperation with CFTC has been ineffective.

A major failing of the current law is that Section 6d does not contemplate criminal prosecutions of commodities or securities violations by the state in a state or a federal forum. Thus, a principal weapon in the federal/state enforcement arsenal, criminal prosecutions by state government, is still absent. Criminal prosecutions constitute a major tool of many state securities law enforcement agencies, and its absence leaves a void which the current civil remedy of Section 6d cannot possibly fill. Emphasis on criminal prosecution ia an area where state law enforcement programs have historically differed from those of federal agencies, in securities and commodities, as well as other regulatory fields. In addition, white-collar crime investigations and prosecutions are often not conducted under "general" antifraud laws under which the states must bring actions in state courts pursuant to Section 6d(7).

Instances where states have attempted to use the injunctive remedy provided in Section 6d have not been productive. For example, the Texas Securities Board recommended one case for injunctive action in federal court, through the Attorney General of Texas and the CFTC, after a securities investigation in early 1981 revealed violations of federal commodities laws. The case was filed jointly by the State of Texas and the CFTC in January 1981. A Temporary Restraining Order was obtained against International Bullion Clearing Corporation and Robert Greenberg. Since that time, Greenberg's lawyer has used a vast assortment of delaying tactics available in federal court to keep that lawsuit in limbo and keep his client from having to pay fines and restitution for violations of the Texas Deceptive Trade Practices Act which were alleged in the same lawsuit.

While the federal court system is an appropriate forum for federal agencies to pursue their regulatory policies, it is not the appropriate forum to carry out the local antifraud programs of state governments. Rather than litigating problems of national interest with national exchanges and multi-national companies, state enforcement programs have tended to concentrate on the confidence games and white-collar crime problems suited for swift state court actions and criminal prosecutions. Unfortunately, injunctive actions against white-collar criminals filed in federal court are usually ineffective. The crook may set up a new corporation and continue operations in some new scam while his lawyers drag out lawsuits by filing a myriad of motions. There are numerous examples of this, but two come quickly to mind.

CFTC filed an injunctive action against United Petroleum Exchange Corporation and Robert Greenberg to stop the sale of fraudulent futures contracts in crude oil. While that action was in its early stages, Greenberg set up International Bullion Clearing Corporation to sell deferred delivery contracts. The CFTC and the State of Texas filed suit against International Bullion Clearing Corporation in January 1981. A hearing on Preliminary Injunction was finally begun on February 8, 1982, after numerous delays. To date there has still been no resolution of this case, though the Defendant remains under a Temporary Restraining Order.

The second instance involves Sami Eisbart who was sued by the CFTC for the sale of fraudulent futures contracts in crude oil. While the lawsuit was pending, Eisbart was instrumental in setting up National Coal Exchange which has allegedly solicited millions of dollars from investors. CFTC, after a long investigation, sued the National Coal Exchange.

The above illustrations indicate that federal courts are not the appropriate forum in which to conduct the white-collar crime programs best suited to state criminal prosecutions. But it is also important to note that the types of actions contemplated for state officials under Section 6d are inappropriate programs for state enforcement efforts. State legislatures seldom willingly appropriate funds for state officials such as attorneys general or securities administrators to enforce federal laws and regulations, as contemplated in Section 6d. Without authority to pursue violations under state law, state officials such as securities administrators lack authority to expend their resources on commodity investigations. Further, an integral weapon in the state enforcement arsenal (though it is absent in current commodity regulation) is criminal prosecution, and many state attorneys general have no authority under their state laws to institute criminal proceedings. Commodities frauds have been investigated in the past by securities administrators because of their similarity to securities frauds, and these frauds would be best investigated and prosecuted by the local officials with local powers of prosecution under local statute. In short, the provisions of Section 6d place the wrong program (white-collar crime enforcement involving commodities) in the wrong forum (federal injunctive proceedings).

The Supreme Court is presently considering whether or not there is a private right of action under the CEA. Presently, the Circuit Courts are split 4 to 3 for a private right of action. Without a private right of action, defrauded investors must rely on the CFTC's reparations procedures. Neither of these methods are effective in combatting the high level of securities fraud. Presently, the CFTC's reparations division has a backlog of over 2,000 cases and in general a case takes over 40 months to its completion. Private rights of actions impose a burden on a defrauded investor who, after already losing his life's savings, must expend time, energy and expense in bringing suit. This can be difficult in the case of a company or operator which has closed up its shop and started anew in a different location with a different name. If the states are granted jurisdiction over the enforcement of commodities frauds, they could bring criminal actions against the fraudulent operators to put them out of business. Private parties could seek to join their claims for damages to such suits or utilize the state's case in presenting his own, if private rights of action are found to exist under the CEA.

Presently, the states have no authority to register commodity operators of any sort. This prevents commodities operators from having to comply with 50 different registration procedures in the states as do registered broker-dealers. NASAA and the NASD are in the process of implementing a Central Registration Depository ("CRD") which will permit a broker-dealer to register with the Securities and Exchange Commission and all the states with one filing and one fee payment. Notwithstanding the progress made with the CRD, state securities commissioners in general do not seek the authority to register commodities professionals. Still, the present system is defective in two respects: the states cannot readily obtain information regarding persons registered with the CFTC who are being investigated for possible fraudulent activity, and these registered persons continue to operate fraudulently as the CFTC is unable to adequately police the persons registered with them. NASAA has proposed, as part of its legislative package, which is discussed below and attached hereto, that certain commodities professionals be required by the CFTC to indicate on their registration filings in which states they are operating. Such information would be forwarded by the CFTC to the appropriate state official. The NASAA proposal would also authorize the appropriate state official to petition the CFTC for the suspension or revocation of the registration of those commodities professionals included in the proposal, and the CFTC would be mandated to promptly act on such petition. Such a procedure puts a minor, if any, regulatory burden on industry and at the same time enables those authorities closest to the fraudulent activities, the state securities administrators to bring such activities to the attention of the CFTC and possibly assist in the CFTC's investigation.

NASAA has submitted to the Committee with this testimony seven proposed amendments to the CEA which are attached hereto. The purpose of these amendments is to return some jurisdiction in the commodities realm to the States. These proposed amendments would preserve CFTC exclusive jurisdiction as to (i) contract market or clearinghouse registration, (ii) the registration of floor commission merchants, floor brokers, dealers and agents operating on a registered contract market (except for authority in the States to petition the CFTC to revoke such registration) and (iii) the contracts for sale on a registered contract market.

The first of these amendments would amend Section 2 so as to define the scope of the exclusive jurisdiction of the CFTC in those areas in which there is a clear national interest. This includes the registration of contract markets or clearinghouses, the registration or licensing of commodity futures commission merchants, floor brokers, dealers agents or salesmen and those transactions traded or executed on a registered contract market.

The second proposed amendment establishes the registration-related authority discussed above. Pursuant to this proposal, the CFTC would inform the appropriate state officials of those registered futures commission merchants, commodity trading advisors, commodity pool operators and associated persons thereof operating within their state. In addition, the states would be authorized to petition for and present evidence sustaining a suspension or revocation of any such person's registration. This amendment would not grant any authority to the states over the actual registration process.

The third proposal would expand the jurisdiction granted in Section 6d(7) of the CEA so as to permit states to bring state administrative and court proceedings under general, commodities or securities antifraud statutes of the state. Presently, the states can only bring actions in state court under general antifraud statutes. The ineffectiveness of that limited authority has been alluded to above. The reinstatement of jurisdiction over exchange and off-exchange transactions as to antifraud matters would restore a basic police power enabling the states to protect their citizens from fraudulent and illegal conduct and would improve the integrity of the national futures market.

The next proposed amendment is, in substance, similar to the amendment to Section 8(e) in Section 17(a) of S. 2109. The purpose of both amendments is to authorize the CFTC to share investigative information with the states for enforcement purposes. The sharing of information has proven to be an effective enforcement tool in the enforcement efforts of the Securities and Exchange Commission and the state securities administrators. In connection with this amendment, NASAA also proposes an amendment to Section 12(a) of the CEA which specifically requires the CFTC to cooperate with the states by sharing enforcement information.

NASAA's sixth proposed amendment is almost identical to Section 20(b) of S. 2109, which adds a new subsection (e) to Section 12 of the CEA. This amendment grants concurrent jurisdiction to the states and to federal authorities other than the CFTC over off-exchange transactions, which are the major source of fraudulent activity, and over persons who fail to register with the CFTC as required. The concurrent jurisdiction granted by this amendment goes to both regulatory and antifraud matters. The language of subsection (3) of NASAA's proposal differs from the CFTC's. The purpose of that change is to place the burden on the unregistered person to negate his duty to register rather than requiring the state official to prove such a duty to register in its case in state court, which may, thereupon, remove the case to federal court as such is a decision of federal law.

NASAA's final amendment grants the states concurrent jurisdiction as to the registration of persons dealing in leverage contracts. Presently, leverage contracts are another source of fraudulent activity and the number of persons who would be required to register would not be so great as to burden industry with substantial expenses. In lieu of authorizing the states to register persons dealing in leverage contracts, NASAA proposes that such persons be included in the amendment regarding notification of operation in the state and state petitioning for revocation of registration.

Congress cannot delay action in this area as thieves continue to loot unsophisticated investors. In 1974, Congress granted exclusive jurisdiction to the CFTC and "the police force was cut from fifty to one in the middle of the crime wave."7/ As fraudulent activity flourished, Congress enacted Section 6d in 1978. This effort has proved futile. Jurisdiction over commodities matters must be returned to the states for the sake of the investing public.

NASAA appreciates being invited to testify in order to give its views on the CFTC's ability to combat fraud and would be pleased to furnish any other information the Committee deems necessary.

7/ Report of the Commodities Task Force of the North American Securities Administrators Association, April 1978, p.8.

North American Securities Administrators Association, Inc.
Proposed Amendments to the
Commodities Exchange Act ("CEA")
and Commentary

1. Section 2(a)(1) of CEA is amended by

   (a) deleting the word "exclusive" after the phrase "Provided, That the Commission shall have"; and

   (b) inserting the following after the phrase "pursuant to section 19 of this Act;"

   > "...and such jurisdiction shall be exclusive as to options transactions, as specified in Section 4c of this Act, and as to commodity futures contract market or clearinghouse registration and as to commodity futures commission merchant, floor broker, dealer, agent or salesmen registration or licensing where such accounts, agreements, and transactions involve contracts for sale of a commodity for future delivery, traded or executed on a contract market designated pursuant to Section 5 of this Act;"

Commentary

The purpose of this amendment is to define the scope of the exclusive jurisdiction of the Commission. Essentially, the need for exclusive federal jurisdiction lies in those transactions on the national commodity market. This amendment grants exclusive jurisdiction to the Commission over the national commodity markets and over the commodities professionals dealing in those national markets to the extent that such professionals register with the Commission. If they fail to register then they are subject to concurrent jurisdiction under number 6 below. This amendment also grants exclusive jurisdiction to the Commission over the contract agreements traded on the exchanges. The exclusive jurisdiction granted by this amendment is limited to regulatory matters insofar as States are granted concurrent jurisdiction in anti-fraud matters under the proposed amendments to Section 6d(7) in number 4 below.

2. The CEA is amended by adding after Section 4p thereof the following new subsection:

   > "4q. The Commission shall require all futures commission merchants, commodity pool operators, commodity trading advisors and asso-

> ciated persons thereof, who are registered or regulated under Section 4d, 4f, 4k, 4m, 4n, 4p or 8a of the Act, to indicate to the Commission in which States they are operating as a floor commission merchant, commodity pool operator, commodity trading advisor or associated person thereof; and shall notify the appropriate official in those States so indicated of such registration for notice purposes. Any appropriate official from a State may petition the Commission to suspend or revoke the registration of any floor commission merchant, commodity pool operator, commodity trading advisor or associated person thereof who is operating within that State, whereupon the Commission shall promptly ascertain whether cause for suspension or revocation exists under Section 8a, paragraph 2(B) or (C) and, if it does exist, proceed under Section 6(b)."

Commentary

The purpose of this amendment is to statutorily grant a means by which State officials can investigate floor commission merchants, commodity pool operators, commodity trading advisors or associated persons thereof against whom they have received complaints and can seek to have such persons' registration suspended or revoked without actually establishing a registration system on the State level. The State official would present evidence sustaining a suspension or revocation to the Commission in a petition requesting such action and the Commission would be required to promptly act upon such petition. In essence, this amendment extends the investigatory powers of the Commission in registration and licensing matters.

3. Section 6d(7) of the Act is amended by

   (a) by striking the word "section" and inserting the word "Act";

   (b) inserting the words "or in a State administrative proceeding" after the words "in State court;" and

   (c) striking "." and adding "or of any general,commodities or securities anti-fraud statute of such State. except that the Commission shall have exclusive jurisdiction over a contract market, clearinghouse on floor broker."

Commentary

The purpose of this amendment is to grant the states concurrent jurisidiction with the Commission with respect to anti-fraud matters as to both exchange traded contracts and off-exchange transactions. This expanded jurisdiction, especially as to exchange traded contracts for off-exchange concurrent jurisdiction is granted in number 6 below, restores a basic police power of the states to protect their citizens from fraudulent and illegal conduct. Its scope is limited to State statutes dealing with such conduct.

4. Section 8(e) of the Act is amended by

   (a) inserting in the third sentence "or of any department or agency of any State after "of the Government of the United States";

   (b) inserting in the fourth sentence "or State" after "to any Federal";

   (c) inserting in the fourth sentence "or the laws of any State" after "of the United States"; and

   (d) inserting in the fourth sentence "or the State" after "or the United States".

Commentary

The purpose of this amendment is to authorize the Commission to share investigative information with the States for use in Federal proceedings under Section 6d of the Act or under State proceedings under Sections 6d(7), 12(e) and 19(e). Without the sharing of such information the States cannot effectively investigate fraudulent activity, especially under the parens patrie actions under Section 6d.

5. Section 12 of the CEA is amended by adding in subsection (a) after "person" the words "and shall specifically cooperate with such department or agency by furnishing information necessary for enforcement purposes."

Commentary

The purpose of this amendment is to mandate cooperation by the Commission with State departments or agencies in connection with the sharing of information for law enforcement purposes. See Commentary to number 4 above regarding the need for States to have access to such information.

Section 12 of the CEA be further amended by adding subsection (e) as follows:

> "(e) Nothing in this Act shall supersede or preempt: (1) any Federal criminal statute; (2) any Federal or State statute, including any rule or regulation promulgated thereunder, that is applicable to any transaction in or involving any commodity, product, right, service or interest which is not conducted on or subject to the rules of a contract market or subject to regulation by the Commission under 4c or 19 of this Act or (3) the application of any Federal or State statute, including any rule or regulation thereunder, to any person who, but for his failure or refusal to obtain registration or designation under the Act, would be under the exclusive jurisdiction of the Commission except as otherwise provided in subsection 7 of Section 6d of the Act. The Commission is authorized to refer any transaction or matter subject to such other Federal or State statutes to any department or agency administering such statutes for such investigation, action or proceeding as the department or agency shall deem appropriate."

Commentary

The purpose of this amendment is to specifically grant concurrent jurisdiction with the Commission to other Federal agencies and to State departments or agencies as to regulatory and anti-fraud matters as to off-exchange transactions and as to persons who fail or refuse to obtain registration or designation under the Act. This language is similar to that included in the Commission's legislative package except that subsection (3) is drafted differently in order that the duty to obtain registration under the Act need not be proved in State court. Rather, the lack of registration will create the concurrent jurisdiction, though the unregistered person may contest its supposed duty to register.

7. Section 19 of the Act is amended by adding the following new subsection:

> "(e) Nothing contained in this Act shall prohibit a State from requiring the registration of persons soliciting or accepting orders for the purchase or sale of the standardized contracts described in subsection (a) of this Section and from promultating rules and regulations with respect thereto insofar as the exercise of such jurisdiction does not conflict

with any provision of the Act or rule, regulation or order thereunder.

Commentary

The purpose of this amendment is to permit the States to register those persons involved in the marketing of standardized leverage contracts. The registration requirements created under this new subsection cannot conflict with the Act or any rules, regulations or orders thereunder. In lieu of this amendment, the persons covered by this subsection should be added in Section 4q as proposed in number 4 above, to include them in the notice from and petition to the Commission procedure created therein in connection with registered persons.

STATEMENT OF THEODORE THOMTE, DIRECTOR, NATIONAL ASSOCIATION OF FUTURES TRADING ADVISORS

MR. CHAIRMAN, SENATORS, LADIES AND GENTLEMEN:

GOOD MORNING. MY NAME IS THEODORE THOMTE. I AM PRESIDENT OF THOMTE & COMPANY, INC., A REGISTERED COMMODITY POOL OPERATOR AND COMMODITY TRADING ADVISOR. I AM A MEMBER OF THE COMMODITY EXCHANGE INCORPORATED (COMEX) AND A MEMBER OF ITS BOARD OF GOVERNORS AS WELL AS A CHARTER MEMBER OF THE ADVISORY BOARD OF THE CENTER FOR THE STUDY OF FUTURES MARKETS AT COLUMBIA UNIVERSITY'S GRADUATE SCHOOL OF BUSINESS ADMINISTRATION. HOWEVER, I AM APPEARING THIS MORNING IN MY CAPACITY AS A DIRECTOR OF THE NATIONAL ASSOCIATION OF FUTURES TRADING ADVISORS (NAFTA). I WELCOME THE OPPORTUNITY TO PRESENT THIS STATEMENT TO THE SENATE COMMITTEE ON AGRICULTURE TO CONSIDER LEGISLATION REAUTHORIZING THE COMMODITY FUTURES TRADING COMMISSION (CFTC).

AS YOU MAY BE AWARE, NAFTA'S MEMBERSHIP IS COMPRISED OF MORE THAN 120 OF THE INDUSTRY'S LEADING COMMODITY TRADING ADVISORS AND COMMODITY POOL OPERATORS WITH OVER $700,000,000 OF CLIENT ASSETS UNDER MANAGEMENT. NAFTA IS A NON-PROFIT PROFESSIONAL ASSOCIATION WHICH SEEKS RESPONSIBLE WAYS TO REPRESENT THE INTEREST OF CTAs AND CPOs TO THE PUBLIC, THE COMMODITY INDUSTRY AND FEDERAL AND STATE REGULATORY AGENCIES. NAFTA FEELS THAT ITS MEMBERS REPRESENT A FAIR CROSS SECTION OF THE CTAs AND THE CPOs CURRENTLY REGISTERED WITH THE CFTC. CONSEQUENTLY, NAFTA BELIEVES THAT IT IS UNIQUELY QUALIFIED TO COMMENT ON THIS SEGMENT OF THE FUTURES INDUSTRY AND THE INVESTING PUBLIC WHOSE CAPITAL IS MANAGED BY CTAs AND CPOs.

BEFORE COMMENCING THE MAIN PORTION OF MY REMARKS, IT MIGHT BE APPROPRIATE TO REITERATE THE CONCLUSION THAT CONGRESS REACHED IN 1974 AND AGAIN IN 1978: "THE ACTIVITIES OF COMMODITY

TRADING ADVISORS AND COMMODITY POOL OPERATORS ARE AFFECTED WITH A NATIONAL PUBLIC INTEREST..." [SECTION 4l OF THE COMMODITY EXCHANGE ACT (THE ACT)]. CONGRESS RECOGNIZED THAT INDIVIDUALLY MANAGED COMMODITY ACCOUNTS PROVIDE A REASONABLE INVESTMENT ALTERNATIVE FOR A NUMBER OF INVESTORS. SIMILARLY, COMMODITY POOLS PROVIDE AN EFFECTIVE VEHICLE FOR SMALL INVESTORS WITHOUT SUFFICIENT FUNDS TO OTHERWISE PARTICIPATE IN THE COMMODITY FUTURES MARKET. FOR EXAMPLE, POOLS OFFER POTENTIAL ADVANTAGES WHICH OTHERWISE MIGHT BE UNAVAILABLE TO AN INVESTOR IF HE WERE TO ENGAGE INDIVIDUALLY IN COMMODITY FUTURES TRANSACTIONS: GREATER TRADING DIVERSIFICATION, LIMITED LIABILITY, PROFESSIONAL TRADING MANAGEMENT, AND REDUCTION IN BROKERAGE COMMISSIONS.

IN ITS HISTORIC 1974 AMENDMENTS TO THE COMMODITY EXCHANGE ACT, CONGRESS CLEARLY INTENDED THAT THE CFTC WOULD SERVE AS THE ONLY REGULATORY BODY EXERCISING JURISDICTION OVER CTAs, CPOs AND COMMODITY FUTURES CONTRACTS GENERALLY. SEE THE ATTACHED APPENDIX STYLED "LEGISLATIVE HISTORY SUMMARY" WHICH OUTLINES CONGRESS' UNAMBIGUOUS, EXPRESS INTENT THAT THE CFTC, THROUGH ITS RULE-MAKING AUTHORITY, WOULD DEVELOP EXPERTISE OVER FUTURES AND, CONCOMITANTLY, A SINGLE, UNIFIED REGULATORY SYSTEM.

CONGRESS ESTABLISHED THIS UNIFORM REGULATORY SCHEME TO PRECLUDE "OVERLAPPING AND DUPLICATIVE REGULATION." AS ADDRESSED IN THE ATTACHED APPENDIX, CONGRESS SPECIFICALLY CONSIDERED AND REJECTED THE AUTHORITY OF THE STATES TO ENFORCE "THEIR LOCAL LAWS."

IT IS NAFTA'S OPINION THAT THE CFTC HAS EFFECTIVELY SATISFIED ITS LEGISLATIVE MANDATE IN MANY AREAS. THAT ROLE, MOREOVER, HAS GROWN VERY DRAMATICALLY DURING THE LAST TWO YEARS, INCLUDING:

(i) THE INCREASING LEVEL OF ENFORCEMENT ACTIVITY INITIATED BY THE CFTC;

(2) THE NUMBER OF NEW CONTRACTS APPROVED BY THAT AGENCY DURING THE LAST YEAR;

(3) THE INCREASED RESPECT AND COOPERATION THAT THE AGENCY HAS RECEIVED FROM OTHER REGULATORY AGENCIES AS WELL AS INDUSTRY PROFESSIONALS;

(4) THE INITIATIVE DISPLAYED BY THE CFTC IN SEEKING TO RESOLVE IMPORTANT JURISDICTIONAL MATTERS — NOT ONLY WITH THE SEC BUT ALSO WITH THE STATES; AND

(5) THE CFTC'S CURRENT LEGISLATIVE PROPOSALS WHICH WILL BETTER DELINEATE ITS ROLE VIS-A-VIS THE SEC AND THE STATES.

TO THE QUESTION OF WHETHER THE CFTC HAS SATISFIED ITS MANDATE AS AN EXPERT REGULATOR IN THE COMMODITIES FIELD, NAFTA'S RESPONSE IS A RESOUNDING YES. NAFTA FEELS VERY STRONGLY THAT THE CFTC HAS PERFORMED IN A MANNER WHICH DEMANDS AN EXTENSION OF ITS AUTHORITY. IN FACT, IT SEEMS APPROPRIATE TO OBSERVE THAT THE QUESTION IS NOT WHETHER THE CFTC SHOULD BE READILY AUTHORIZED BUT WHAT REFINEMENTS ARE APPROPRIATE TO ITS CONGRESSIONAL MANDATE.

IN THAT CONTEXT, I WOULD LIKE TO ADDRESS CERTAIN SPECIFIC AREAS WHICH HAVE ARISEN DURING CONSIDERATION OF THE CFTC'S REAUTHORIZATION:

(1) CFTC/SEC JURISDICTIONAL ACCORD. IN DECEMBER, FOLLOWING EXTENDED DISCUSSIONS BETWEEN THEIR RESPECTIVE STAFFS AND CHAIRMEN, THE CFTC AND THE SEC FOR THE FIRST TIME ESTABLISHED BASIC GROUND RULES OF JURISDICTION BETWEEN THESE TWO AGENCIES. NAFTA IS IN BASIC AGREEMENT WITH SUCH ACCORD AND THE LEGISLATIVE PROPOSALS WHICH HAVE GROWN OUT OF THOSE DISCUSSIONS. NAFTA STRONGLY FEELS THAT SUCH RESOLUTION IS VERY MUCH IN THE PUBLIC INTEREST AND SHOULD BE APPROVED LARGELY AS SUBMITTED.

WITH REGARD TO COMMODITY POOLS SPECIFICALLY, IT IS RECOGNIZED THAT THE SEC WILL BE ABLE TO INVOKE THE

SECURITIES ACT OF 1933, THE SECURITIES EXCHANGE ACT OF 1934 AND THE INVESTMENT COMPANY AND INVESTMENT ADVISERS ACTS OF 1940. AS WE UNDERSTAND IT, THE BASIC IMPORT OF THIS AGREEMENT IS THAT INTERESTS IN POOLS ARE SECURITIES REQUIRING REGISTRATION WITH THE SEC, UNLESS EXEMPT. STATE SECURITY "BLUE SKY" REGULATION OF POOLS IS SPECIFICALLY PREEMPTED, INCLUDING ALL MATTERS RELATING TO THE OPERATIONS OF POOLS.

(2) STATE JURISDICTION. NAFTA STRONGLY SUPPORTS WELL-DESIGNED DISCLOSURE STANDARDS AS WELL AS DILIGENT ENFORCEMENT OF ANTIFRAUD STANDARDS BY FEDERAL AND STATE AUTHORITIES. IN FACT, IN ITS RECENT COMMENT LETTER TO THE CFTC, NAFTA URGED THE CFTC TO TAKE A GREATER ENFORCEMENT ROLE IN THE AREA AND TO ENCOURAGE SUPPLEMENTAL ENFORCEMENT BY THE STATES. NAFTA BELIEVES THAT THE STATES' ENFORCEMENT EXPERIENCE PROVIDES A VALUABLE SUPPLEMENT TO THE CFTC'S ANTIFRAUD ENFORCEMENT EFFORTS. IN THIS FASHION, WE BELIEVE THE PUBLIC WILL BE BETTER PROTECTED AGAINST FRAUDS WHILE AT THE SAME TIME THOSE LEGITIMATE OPERATORS IN THE INDUSTRY WILL BE SUBJECTED TO ONLY ONE UNIFORM, NATIONAL SCHEME OF REGULATION RATHER THAN FIFTY ADDITIONAL "RULE BOOKS". WITH REGARD TO MATTERS SUBJECT TO THE CFTC'S JURISDICTION, THE STATES, AS ALWAYS, POSSESS THE AUTHORITY AND SHOULD BE ENCOURAGED TO (i) PURSUE CRIMINAL ACTIONS UNDER THEIR EXISTING STATE STATUTES AND/OR (ii) ENFORCE ANY VIOLATIONS OF THE ACT. MOREOVER, WHERE ACTIVITIES FALL OUTSIDE OF THE CFTC'S JURISDICTION, THE STATES SHOULD AGGRESSIVELY INVESTIGATE AND, WHERE APPROPRIATE, PROSECUTE ANY FRAUDS PURSUANT TO THEIR TRADITIONAL AUTHORITY.

NAFTA BELIEVES THAT THE STATES AND THE CFTC SHOULD DECLARE AN "OPEN SEASON" ON ALL FRAUDS, WITH THE STATES

CONCENTRATING THEIR EFFORTS ON OFF-EXCHANGE SITUATIONS. NAFTA FEELS THAT THE STATES ALREADY HAVE THE AUTHORITY TO INVESTIGATE AND, WHERE APPROPRIATE, PROSECUTE FRAUD. WE, OF COURSE, SUPPORT ANY EFFORT TO CLARIFY THAT THE STATES HAVE SUCH AUTHORITY. IN THAT SPIRIT, THE CFTC HAS PROPOSED LEGISLATION WHICH WILL ADDRESS THESE VERY CONCERNS:

(1) PROPOSED SECTION 8(e) OF THE ACT WOULD SPECIFICALLY PERMIT THE CFTC TO SHARE OTHERWISE CONFIDENTIAL INFORMATION WITH THE STATES; AND

(2) PROPOSED SECTION 12(e) WOULD EXPRESSLY PROVIDE THAT ANY STATE OR FEDERAL STATUTES RELATING TO A COMMODITY NOT TRADED ON A CONTRACT MARKET ARE NOT PREEMPTED.

NAFTA BELIEVES THAT ADOPTION OF SUCH CFTC LEGISLATIVE PROPOSALS DURING ITS REAUTHORIZATION CONSIDERATION WILL PROVIDE AN EFFECTIVE FRAMEWORK RESPONSIVE TO THESE CONCERNS.

(3) NATIONAL FUTURES ASSOCIATION (NFA). THE CFTC'S RECENT REGISTRATION OF THE NFA WILL FURTHER ENHANCE THE REGULATORY SCHEME FOR COMMODITY TRADING. THE INCREASING ROLE TO BE BORNE BY NFA WILL RELIEVE THE CFTC OF A SIGNIFICANT PART OF ITS CURRENT REGULATORY RESPONSIBILITIES UNDER THE ACT. THE NFA'S ASSUMPTION OF THESE REGULATORY FUNCTIONS WILL BETTER ENABLE THE CFTC TO DEVOTE MORE OF ITS SCARCE RESOURCES TO IMPROVEMENTS IN THE INDUSTRY, INCLUDING MORE PROMPT REVIEW OF PROPOSED NEW FUTURES CONTRACTS; ANY NECESSARY REVISIONS TO CONTRACT MARKET RULES TO ASSURE COMPETITIVE, EFFICIENT AND FREE MARKETS; MONITORING OF NEW PRODUCTS, SUCH AS COMMODITY OPTIONS; AND AGGRESSIVE ENFORCEMENT OF STRICT ANTIFRAUD STANDARDS.

NAFTA CONCURS WITH THE VIEW THAT REGISTRATION OF THE NFA WILL RESULT IN (i) MORE EFFECTIVE POLICING BY THE FUTURES

INDUSTRY ITSELF OF THOSE SEGMENTS OPERATING OUTSIDE THE SYSTEM OF EXCHANGE STANDARDS AND SURVEILLANCE; AND (ii) BETTER COST CONTROL OVER REGULATORY EXPENSES BY ELIMINATING DUPLICATION, OVERLAP, AND CONFLICT BETWEEN EXISTING GOVERNMENTAL AND SELF-REGULATORY PROGRAMS, AND BY FACILITATING A REDUCTION IN THE COST OF FEDERAL REGULATION — FOR THE BENEFIT OF TAXPAYERS IN GENERAL AND MARKET USERS IN PARTICULAR.

(4) USER FEES. THE CFTC, SUPPORTED BY THE OFFICE OF MANAGEMENT AND BUDGET, HAS PROPOSED THAT EVERY FUTURES TRANSACTION EFFECTED ON AN EXCHANGE WILL BE SUBJECT TO A USER FEE. THOSE AGGREGATE FEES — REALLY AN EXCISE TAX — WILL BE IN ADDITION TO FEES ASSESSED UPON COMMODITY PROFESSIONALS REQUIRED TO JOIN THE NFA. NAFTA SHARES THE OPINION THAT SUCH A TAX IS INDEFENSIBLE FROM RATIONAL PRINCIPLES OF ECONOMIC POLICY OR REGULATORY REFORM. CERTAINLY, ENACTMENT OF SUCH A TAX IS A PERVERSION OF THE PRINCIPLES UPON WHICH THE NFA WAS CREATED SINCE IT WOULD DEPRIVE THIS TITLE III SELF-REGULATORY ORGANIZATION OF ITS FUNDING BASE AND, MORE SIGNIFICANTLY, OVER THE LONG TERM WOULD DESTROY ITS ABILITY TO DEVELOP RATIONAL REGULATORY PROGRAMS FROM THE VERY INDUSTRY PARTICIPANTS IT NEEDS SIGNIFICANT, CONTINUING COOPERATION.

(5) ASSOCIATED PERSON STATUS OF COMMODITY TRADING ADVISORS AND POOL OPERATORS. UNDER PROPOSED REVISIONS TO SECTIONS 4k(2) AND 4k(3) OF THE ACT, A NEW CATEGORY OF REGISTRATION WILL BE MANDATED FOR ANY NON-CLERICAL PERSON WHO SOLICITS INDIVIDUALLY MANAGED ACCOUNTS OF CTAs OR INTERESTS IN COMMODITY POOLS OFFERED BY CPOs. DATING BACK TO 1980, NAFTA IS ON RECORD AS SUPPORTING THIS CONCEPT. NAFTA BELIEVES THAT AN EXAMINATION OF THE FITNESS OF THESE PERSONS IS JUSTIFIED AND IN THE PUBLIC INTEREST.

(6) TRAINING AND EXPERIENCE PROPOSALS. UNDER THIS PROPOSED REVISION, SECTION 4p WOULD EXPAND TESTING AND QUALIFICATIONS AUTHORITY TO ALL REGISTRANTS OF THE ACT. SO LONG AS THE TRAINING AND EXPERIENCE REQUIREMENTS THAT ARE ENVISIONED TRULY RELATE TO MEASURES OF COMPETENCY, NAFTA WOULD, OF COURSE, SUPPORT THIS PROVISION.

NAFTA BELIEVES, HOWEVER, THAT THE NFA, RATHER THAN THE CFTC, SHOULD BE THE APPROPRIATE BODY TO ESTABLISH SUCH STANDARDS. OUR PRINCIPAL CONCERN RELATES TO THE FACT THAT A TRAINING AND EXPERIENCE REQUIREMENT, IF ARBITRARILY ESTABLISHED, COULD RESULT IN SIGNIFICANT BARRIERS TO ENTRY INTO OUR INDUSTRY.

FOR EXAMPLE, REQUIRING A CTA OR CPO REGISTRANT TO HAVE A PRIOR THREE YEAR HISTORY IN THE COMMODITY INDUSTRY WOULD FORECLOSE PROMISING TRADING ADVISORS AND POOL OPERATORS FROM ENTERING THE INDUSTRY. SIMILARLY, ESTABLISHING A NET CAPITAL REQUIREMENT FOR POOL OPERATORS OR TRADING ADVISORS WOULD APPEAR TO BE IRRELEVANT TO THEIR ROLE IF SUCH PERSONS OR ENTITIES DO NOT IN FACT HANDLE CUSTOMER FUNDS. FINALLY, WE NOTE THE NFA HAS PROPOSED ADOPTION OF ETHICAL STANDARDS, FURTHER ENHANCING THE PROFESSIONALISM IN THE INDUSTRY. NAFTA LOOKS FORWARD TO CONTINUING TO WORK WITH THE NFA TO DEVELOP WELL-DESIGNED, REALISTIC STANDARDS OF ETHICS FOR PROFESSIONALS IN THE INDUSTRY.

(7) MARGINS. A RECENT SPATE OF ACTIVITY HAS REVOLVED AROUND THE MEANING OF MARGINS WITH REGARD TO COMMODITIES AND THEIR APPROPRIATE LEVEL. WHILE NAFTA RECOGNIZES THE ROLE THE FEDERAL RESERVE BOARD PERFORMS WITH REGARD TO SECURITIES PURSUANT TO SECTION 7 OF THE SECURITIES EXCHANGE ACT OF 1934, NAFTA NONETHELESS BELIEVES VERY STRONGLY THAT MARGINS WITH REGARD TO COMMODITIES ARE AN ENTIRELY DIFFERENT ANIMAL. COMMODITY MARGINS ARE NOT BORROWED

FUNDS BUT RATHER REPRESENT A GOOD FAITH DEPOSIT ON WHICH NO INTEREST IS PAID. ACCORDINGLY, NAFTA CONTINUES TO FEEL THAT MARGINS SHOULD BE DETERMINED BY THE CFTC AND/OR THE EXCHANGES.

(8) LENGTH OF REAUTHORIZATION. IN BOTH THE 1974 AND 1978 AMENDMENTS, CONGRESS PROVIDED THAT APPROPRIATIONS FOR THE CFTC SHOULD BE RECONSIDERED BY CONGRESS AT THE END OF FOUR YEARS. AFTER TWO SUCH PERIODS OF "SUNSET" REVIEW, NAFTA FEELS VERY STRONGLY THAT REAUTHORIZATION SHOULD BE EXTENDED FOR A PERIOD LONGER THAN FOUR YEARS — PREFERABLY 6 TO 10 YEARS. ADOPTION OF A 6 YEAR REAUTHORIZATION PROVISION WOULD NOT, OF COURSE, PRECLUDE CONGRESS FROM TAKING ACTION IN ANY SPECIFIC AREA IT DEEMED APPROPRIATE. WHAT IT WOULD DO IS TO PERMIT THE CFTC TO MORE EFFECTIVELY MARSHALL ITS LIMITED RESOURCES IN WAYS THAT WOULD BETTER PROTECT THE PUBLIC RATHER THAN DIVERTING A SIGNIFICANT AMOUNT OF TIME, PERSONNEL AND MONEY TO THIS QUADRENNIAL REEXAMINATION. NAFTA FEELS THAT SUCH FREQUENT SCRUTINY HEREAFTER IS NO LONGER WARRANTED NOR COST JUSTIFIED.

(9) TECHNICAL MATTERS. NAFTA ALSO SUPPORTS CERTAIN TECHNICAL MATTERS WHICH ARE THE SUBJECT OF THE AMERICAN BAR ASSOCIATION AND CFTC LEGISLATIVE PROPOSALS. THESE INCLUDE:

(a) THE ABA PROPOSAL TO EXEMPT FROM REGISTRATION AS A COMMODITY POOL (i) ANY BENEFIT PLAN SUBJECT TO THE PROVISIONS OF ERISA AND (ii) ANY GROUPS OF PERSONS FIVE OR FEWER IN NUMBER;

(b) THE CFTC PROPOSAL TO DEFINE A CTA TO EXCLUDE CASH COMMODITIES;

(c) THE ABA PROPOSAL TO EXTEND THE EXEMPTION FROM THE DEFINITION OF COMMODITY TRADING ADVISOR TO ENCOMPASS NOT ONLY PRINT BUT ALSO BROADCAST MEDIA.

IN RESPONSE TO THE CFTC PROPOSAL TO AMEND SECTION 4k(1) TO DEEMPHASIZE THE "AGENT" CATEGORY AND SUBSTITUTE ASSOCIATED PERSONS REGISTRATION THEREFOR, THE ABA HAS SUGGESTED THE ALTERNATIVE STATUS OF "INTRODUCING BROKER." NAFTA SUPPORTS THE ABA INTRODUCING BROKER APPROACH AS A MORE APPROPRIATE AND EFFECTIVE MEASURE TO REGULATE THESE MARKET PROFESSIONALS.

IN CONCLUDING OUR REMARKS, I WOULD LIKE TO REEMPHASIZE THAT NAFTA STRONGLY SUPPORTS REAUTHORIZATION FOR THE CFTC AND ITS EXCLUSIVE JURISDICTION. WE FEEL THAT THE AGENCY HAS ACQUITTED ITSELF EFFECTIVELY IN VERY DIFFICULT TIMES AND CIRCUMSTANCES. NAFTA ALSO SUPPORTS THE SIGNIFICANT ENFORCEMENT ACTIVITIES OF THE STATES IN COORDINATION WITH AND AND SUPPLEMENTAL TO THE ACTIVITIES OF THE CFTC UNDER THE ACT.

NAFTA IS HOPEFUL THAT THE CFTC WILL RETAIN ITS EXCLUSIVE JURISDICTION OFFER "ACCOUNTS, AGREEMENTS ... AND TRANSACTIONS INVOLVING CONTRACTS OF SALE FOR FUTURE DELIVERY TRADED OR EXECUTED ON A CONTRACT MARKET"; AND THAT THE PERMISSIBLE ROLE THE STATES MAY PURSUE IN ENFORCING OFF-EXCHANGE COMMODITIES WILL BE EXPRESSLY STATED AND DELINEATED. IF THESE MATTERS ARE ACCOMPLISHED DURING THIS CONSIDERATION OF REAUTHORIZATION, NAFTA IS CONFIDENT THAT UPON THE NEXT SUNSET REVIEW OF THE CFTC, THE COMMODITY INDUSTRY WILL BE MARKED WITH NEW PRODUCTS MORE RAPIDLY APPROVED BY THE CFTC; REDUCED TENSION BETWEEN THE SEC AND THE CFTC; AND GREATER ENFORCEMENT EFFORTS ON THE PART OF THE CFTC AND THE STATES.

I WOULD BE PLEASED TO RESPOND TO ANY QUESTIONS YOU MAY HAVE. THANK YOU VERY MUCH.

APPENDIX

LEGISLATIVE HISTORY SUMMARY

THE REGULATION OF COMMODITY FUTURES TRADING DATES BACK TO 1921. FROM THAT VERY FIRST COMMODITY ACT PASSED BY CONGRESS

TO DATE, THE SCHEME OF REGULATION OVER COMMODITIES HAS PROGRESSED QUITE DRAMATICALLY FROM A MEASURE PRINCIPALLY PROTECTING FARM INTERESTS TO A GENERAL SCHEME OF INVESTOR/CONSUMER PROTECTION.

AS AN OUTGROWTH OF THE 1974 AMENDMENTS TO THE COMMODITY EXCHANGE ACT (THE CEA), CONGRESS MANDATED THE CREATION OF THE CFTC TO DEVELOP EXPERTISE OVER FUTURES. BY ITS ACTION, CONGRESS CLOAKED THE CFTC WITH THE CENTRALIZED AUTHORITY, AND IMPOSED THE RESPONSIBILITY, TO DEVELOP A COHERENT REGULATORY PROGRAM ENCOMPASSING FUTURES TRADING AND RELATED ACTIVITIES. REGRETABLY, IT IS FREQUENTLY OVERLOOKED THAT THE CEA IS IN MANY WAYS A TOUGHER MEASURE THAN THE SOMEWHAT PARALLEL SECURITIES EXCHANGE ACT OF 1934, THE MODEL AGAINST WHICH IT IS SO FREQUENTLY MEASURED. AMONG OTHER SIGNIFICANT POWERS GROWING OUT OF THAT LANDMARK LEGISLATION, THE CEA PROVIDES FOR POWERFUL EMERGENCY AND INJUNCTIVE PROVISIONS; $100,000 CIVIL PENALTIES PER OFFENSE; REPARATIONS PROCEDURES FOR INJURED INVESTORS; STRICT SEGREGATION AND SAFEGUARDING OF INVESTOR FUND PROVISIONS; AND NO REQUIREMENT IN FRAUD ACTIONS FOR A PURCHASE OR SALE TO BE ESTABLISHED.

ONE OF THE SIGNIFICANT POWERS GRANTED TO THE CFTC IN 1974 WAS ITS AUTHORITY TO EXERCISE "EXCLUSIVE JURISDICTION" UNDER SECTION 2(a)(1). THAT SECTION SPECIFICALLY PROVIDES THAT THE CFTC SHALL HAVE EXCLUSIVE JURISDICTION OVER:

> " ... ACCOUNTS, AGREEMENTS ... AND TRANSACTIONS INVOLVING CONTRACTS OF SALE OF A COMMODITY FOR FUTURE DELIVERY, TRADED OR EXECUTED ON ANY CONTRACT MARKET ... OR ANY OTHER BOARD OF TRADE, EXCHANGE OR MARKET ... PROVIDED ... THAT EXCEPT AS HEREIN ABOVE PROVIDED, NOTHING CONTAINED IN THIS SECTION SHALL (i) SUPERSEDE OR LIMIT THE JURISDICTION AT ANY TIME CONFERRED ON THE SECURITIES AND EXCHANGE

> COMMISSION OR REGULATORY AUTHORITIES UNDER THE LAWS OF THE UNITED STATES OR OF ANY STATE, OR (ii) RESTRICT THE SECURITIES AND EXHANGE COMMISSION AND SUCH OTHER AUTHORITIES FROM CARRYING OUT THEIR DUTIES AND RESPONSIBILITIES IN ACCORDANCE WITH SUCH LAWS."

NOT WITHSTANDING THE SIGNIFICANT EVOLUTION AND PROTECTIONS NOW AFFORDED UNDER THE CEA, IT IS APPARENT THAT FROM INCEPTION THE CONGRESSIONAL GRANT OF "EXCLUSIVE JURISDICTION" TO THE CFTC HAS RAISED A HOST OF QUESTIONS. IN REALITY, THE CFTC HAS EXCLUSIVE JURISDICTION IN CERTAIN AREAS ONLY; SHARES JURISDICTION WITH OTHER REGULATORS IN ADDITIONAL AREAS; AND NO JURISDICTION IN ALL REMAINING AREAS.

IT IS CLEAR THAT THE COMMODITY MARKETS ARE NOT ONLY NATIONAL BUT ALSO INTERNATIONAL IN SCOPE. CONGRESS RECOGNIZED THAT IN ITS ORIGINAL GRANT OF POWER IN 1974, CONCLUDING THAT A CROSSFIRE OF INAPPROPRIATE AND ARBITRARY REGULATION MIGHT OTHERWISE RESULT. THAT AUTHORITY WAS STRENGTHENED BY CONGRESS IN THE 1978 AMENDMENTS. THE SOUNDNESS OF DELEGATING RESPONSIBILITY TO A SINGLE EXPERT REGULATOR OF COMMODITY FUTURES CONTRACTS IS EVEN MORE CRITICAL TODAY. A SIGNIFICANTLY GREATER NUMBER OF COMMODITIES MAY BECOME THE SUBJECT OF FUTURES TRADING. OTHERWISE, AS CHICAGO BOARD OF TRADE PRESIDENT ROBERT WILMOUTH RECENTLY STATED, "THERE IS AN ALARMING POTENTIAL FOR A NEARLY INFINITE POLIFERATION OF THE OVERLAPPING AND DUPLICATIVE REGULATION CONGRESS SOUGHT TO AVOID AND THEREFORE AN URGENT NEED FOR STRICT ADHERENCE TO THE EXCLUSIVE JURISDICTION PROVISIONS OF THE ACT" VESTED BY CONGRESS IN THE CFTC.

A THOROUGH READING OF THE CEA AND ITS ASSOCIATED LEGISLATIVE HISTORY MAKES IT CLEAR THAT CONGRESS INTENDED TO DELEGATE TO THE CFTC THE PREEMINENT POSITION WITH REGARD TO COMMODITY FUTURES CONTRACTS TRADED ON THE EXCHANGES AND TO

HAVE AN IMPORTANT ROLE IN COMMODITY RELATED ACTIVITIES GENERALLY.

THE CEA AND ITS LEGISLATIVE HISTORY GROWING OUT OF THE 1974 AND 1978 AMENDMENTS UNAMBIGUOUSLY EXPRESS CONGRESSIONAL INTENT TO VEST THE CFTC WITH EXCLUSIVE JURISDICTION OVER ADVISORS, POOL OPERATORS AND COMMODITY FUTURES IN GENERAL. THE EXPRESS INTENT OF THIS LEGISLATIVE HISTORY WAS TO REMOVE JURISDICTION FROM STATE OR FEDERAL AGENCIES TO REGULATE THOSE PARTS OF THE COMMODITY INDUSTRY WHICH CONGRESS HAD DELEGATED TO THE CFTC.

FOR EXAMPLE IN PRESENTING THE FINAL COMPROMISE BILL CONTAINED IN THE 1974 AMENDMENTS, SENATE FLOOR LEADERS DESCRIBED THE EXCLUSIVE JURISDICTION PROVISIONS OF THE AMENDMENTS AS "AN ATTEMPT TO AVOID UNNECESSARY OVERLAPPING AND DUPLICATIVE REGULATIONS." THE CONFERENCE REPORT THEN DETAILED THE PARAMETERS OF THIS EXCLUSIVE GRANT OF JURISDICTION:

> "UNDER THE EXCLUSIVE GRANT OF JURISDICTION TO THE COMMISSION, THE AUTHORITY IN THE COMMODITY EXCHANGE ACT (AND REGULATIONS ISSUED BY THE COMMISSION) WOULD PREEMPT THE FIELD INSOFAR AS FUTURES REGULATION IS CONCERNED. THEREFORE, IF ANY SUBSTANTIVE STATE LAW REGULATING FUTURES TRADING WAS CONTRARY OR INCONSISTENT WITH FEDERAL LAW, FEDERAL LAW WOULD GOVERN. IN VIEW OF THE BROAD GRANT OF AUTHORITY TO THE COMMISSION TO REGULATE THE FUTURES INDUSTRY, THE CONFEREES DO NOT CONTEMPLATE THAT THERE WILL BE A NEED FOR ANY SUPPLEMENTARY REGULATIONS BY THE STATES."

THUS, CHAIRMAN TALMADGE STATED IN THE SENATE DURING FLOOR DEBATES ON THE 1974 AMENDMENTS: "IN ESTABLISHING THIS COMMISSION, IT IS THE COMMITTEE'S INTENT TO GIVE IT EXCLUSIVE JURISDICTION OVER THOSE AREAS DELINEATED IN THE ACT."

MOREOVER, THE SENATE COMMITTEE, IN ITS REPORT ON THE 1974

AMENDMENTS EMPHASIZED THAT: "THE COMMITTEE WISHED TO MAKE CLEAR THAT WHERE THE JURISDICTION OF THE COMMODITY FUTURES TRADING COMMISSION IS APPLICABLE, IT MAY SUPERSEDE THE STATE AS WELL AS FEDERAL AGENCIES." STILL FURTHER, AND CONSISTENT WITH THE SECTION 2(a)(1) GRANT OF EXCLUSIVE JURISDICTION TO THE CFTC, WAS THE 1974 REPEAL OF SECTION 4(c) OF THE ACT WHICH HAD PROVIDED THAT "NOTHING IN THAT SECTION OR SECTION 4(b) SHALL BE CONSTRUED TO IMPAIR ANY STATE LAW APPLICABLE TO ANY TRANSACTION ENUMERATED OR DESCRIBED IN SUCH SECTION." HENCE, THE 1974 AMENDMENT STRUCK THE ONLY LANGUAGE IN THE ACT WHICH HAD SPECIFICALLY RESERVED REGULATORY AUTHORITY TO THE STATES.

ACCORDING TO A PRINCIPAL SENATE SPONSOR, CONGRESS SOUGHT TO ESTABLISH "A COHESIVE NATIONAL POLICY OF COMMODITY REGULATION TO BE ADMINISTERED BY THE CFTC." CONGRESS REITERATED THE NEED FOR A SINGLE COMMON NATIONAL POLICY FOR FUTURES MATTERS WHEN IT AMENDED THE CEA IN 1978. IN ENACTING THIS LIMITATION OF STATE ACTIVITIES IN 1978, CONGRESS SPOKE OF THE NECESSITY FOR A "SINGLE, UNIFIED SYSTEM" AND A "COHERENT AND CONSISTENT ... NATIONAL POLICY" FOR FUTURES. MOREOVER, CONGRESS MADE IT CLEAR THAT SECTION 6d GAVE THE STATES NO AUTHORITY TO SET THEIR OWN POLICIES IN FUTURES RELATED AREAS. CONGRESS SPECIFICALLY REJECTED STATE ATTEMPTS TO AMEND THE ACT SO AS TO PERMIT STATE REGULATION OF COMMODITY POOL OPERATORS. INSTEAD, CONGRESS ADOPTED SECTION 6d WHICH GIVES TO THE STATES A SPECIAL, LIMITED ROLE TO ENFORCE PROVISIONS OF THE CEA AND THE CFTC'S REGULATIONS — AND ONLY THOSE PROVISIONS — IN FEDERAL COURTS SPECIFING THE PROCEDURES WHICH MUST BE ADHERED TO IN SUCH ACTIONS.

IN ENACTING SECTION 6d, CONGRESS CAREFULLY NOTED THAT THE STATES WOULD NOT IN THESE SUITS BE ENFORCING "THEIR LOCAL LAWS" BUT RATHER CFTC POLICIES, AND THAT THE PROVISION WAS "[C]ONSISTENT WITH THE COMMISSION'S EXCLUSIVE JURISDICTION AND

PREEMPTION OF STATE REGULATORY ACTIVITY ENACTED IN 1974 ..." CONGRESS AGAIN SPOKE OF THE NEED FOR A "COHERENT AND CONSISTENT ... NATIONAL POLICY" FOR FUTURES. INDEED, TO INSURE A NATIONAL POLICY ESTABLISHED BY THE CFTC, CONGRESS SPECIFIED IN SECTION 6d THAT STATE REGULATORS MUST IMMEDIATELY NOTIFY THE CFTC OF ANY ACTIONS BROUGHT BY THEM UNDER THIS SECTION AND THAT THE CFTC MAY INTERVENE IN ANY SUCH ACTION.

STATEMENT OF CLINTON BURR, GENERAL COUNSEL, RONENTHAL & COMPANY, CHICAGO, ILLINOIS

My name is Clinton Burr. For three years I worked for the Commodity Futures Trading Commission ("CFTC") in Washington, D.C. where I was involved in the CFTC's Reparations program from its very beginning until mid-1978. Since then I have been General Counsel for Rosenthal & Company ("Rosenthal"), a Chicago based commodity brokerage firm. As counsel for Rosenthal, I have tried or settled cased in the state courts, the federal courts and in the CFTC's Reparations forum. Most of my work has been in the CFTC's Reparations forum.

There is considerable concern over Reparations proceedings conducted by the CFTC because of the delays, the growing backlog and the lack of finality in the decisions.[1] Many advocate that this Congress should repeal Section 14 of the Commodity Exchange Act ("CEA"), which authorizes the CFTC to conduct Reparations proceedings and thereby the program would be eliminated. This would be unfortunate because the CFTC provides a national dispute resolution forum which is free from allegations of industry bias or local prejudice.

The CFTC's Administrative Law Judges ("ALJ's") are now experts in the field of commodity trading - and they are aware of the possible abuses. As a result, a Reparations trial takes one-fifth the time of civil litigation and, without the need for local counsel in the various state courts, the expense of a Reparations trial is one-tenth that of state or federal court litigation. There is no need for parties to retain expert witnesses in order to educate a new judge or jury for each trial. There are no expensive or time-consuming pre-trial or post-trial hearings. The CFTC offers all parties nationwide service of process and subpoena power.

---

[1] "Program to Decide Trade Battles A Nightmare," Chicago Tribune, December 20, 1979.

The CFTC also advoctes that the Section 14 of the CEA be amended to eliminate the requirement that these proceedings be conducted pursuant to the Administrative Procedures Act. The CFTC offers no justification for this proposal other than it would expedite the process for "younger attorneys" to decide cases instead of the ALJ's.[2]

The problem with the CFTC Reparations forum is not with the statute. Rather the problem is with the CFTC's administration of the statute. There have been no fewer than six complete audits of the CFTC's Reparations program since it began operating six years ago.[3] Every one of them has come to the same conclusion: the problem is the internal management of the CFTC.

In 1978 during the Reauthorization Hearings before this Committee, the Comptroller General submitted an extensive audit prepared by the General Accounting Office ("GAO").[4] The report's conclusions were that the CFTC has neglected this program by failing to devote more than minimal resources to the program; cases are not immediately assigned to the ALJ's thereby creating pre-trial delays; and the Commission has not developed any standards so that the ALJ's, or the Commission's appellate review section, would be encouraged to maintain high productivity.

2/ "Reparations to Be Key Issue in CFTC Reauthorization," Susan Burkhardt, Commodity News Service, February 16, 1982.

3/ (a) "Operational Review of the Office of Hearings & Appeals", James South, 32 pages, June 24, 1977; (b) "Report to the House Committee on Appropriations" ("Whitten Report"), 95th Cong., 2d Sess. February 22, 1978; (c) "Regulation of the Commodity Futures Markets - What Needs to be Done" ("GAO Report"), Government Accounting Office, May 17, 1978; (d) "Operational Review of the Division of Enforcement's Reparations Unit," John Field III, November 27, 1978; (e) "Reparations Improvement," Robert Joost, October 30, 1979; and (f) Government Accounting Office Audit of 1982. See Testimony of Comptroller General before Senate Committee on Agriculture, March 2, 1982.

4/ "Regulation of the Commodity Futures Markets - What Needs to be Done," General Accounting Office, May 17, 1978.

The CFTC responded to the GAO report on July 14, 1978[5] with assurances to this Committee that the problems cited by the GAO would be remedied in short order. The CFTC then initiated another extensive internal audit which filed a 97 page report with suggested changes for the complaint filing process. The format for the original screening function was revised and improved, otherwise, the GAO's suggestions were neglected for another three years until the CFTC began to prepare a response to the new 1982 GAO report.

Now this Commission is proposing that Congress delete the only aspect of Section 14 which establishes criteria and standards for the adjudication of Reparations cases - the Administrative Procedures Act.

They have not prepared a proposal which contains the procedures which they would institute. They have not offered any data or a study showing how their unknown proposals will expedite the process. Nor have they offered any data concerning the amount of the tax dollars presently expended and how the new, unknown proposals will be more cost-effective.

The CFTC proposal on Reparations is merely asking the Congress to delegate the legislative function to the Executive branch so that it may enact a new judicial or dispute resolution forum within the agency. And at the same time the CFTC is asking Congress to abrogate an individual's right to appeal with the proposed provision that appeals may only be taken "with the permission of the CFTC."

This proposal is not dissimilar to the procedural rules employed by 16th Century Spain at the time of the Inquisition.

I submit that the new CFTC proposal is little more than a smoke screen. Under the proposed Section 14b,[6] the CFTC is asking for no more powers than it already has. The present rules employed by the CFTC are those which this Commission promulgated in 1976. See CFTC Regulations 12.21-12.32, 17 C.F.R. §12.21-12.32, 41 Fed. Reg. 3995 (January 27, 1976). The Commission, by rule making proceeding, could change the rules of practice to alter the form, filing and service of pleadings or orders. The Rules relating to discovery procedures, Rules 12.61-12.65 are there because the CFTC made a conscious decision in January 1976, not to allow the parties an opportunity to take oral depositions. Now that time has proven that parties are ill-prepared at the time of trial because they have not been able to depose or obtain accurate information from the opposing party, the CFTC is claiming this is a statutory problem and it is asking the Congress to give the CFTC a rule-making power so that it may promulgate rules relating to discovery. This power was exercised in 1976 by the CFTC.

---

[5] "Responses to the Report by the Comptroller General," CFTC, July 14, 1978.

Regarding the CFTC's request for statutory authority to award counterclaims, the CFTC has gone on record with the statement that such authority was contained in the 1974 Amendments and the Commission has been awarding counterclaims.[7]

---

[6] Proposed Section 14b: "The Commission may promulgate such rules, regulations and orders as it deems necessary or appropriate for the efficient and expeditious administration of this section. Notwithstanding any other provision of law, such rules, regulations, and orders may prescribe without limitation, the form, filing and service of pleadings or orders; the nature and scope of discovery; counterclaims; motion practice (including the grounds for dismissal of any claim or counter- claim); hearings (including the waiver thereof, which may relate to the amount in controversy); rights of appeal, if any; and all other matters governing proceedings before the Commission under this section."

[7] Delphine Friedman v. Dean Witter & Co. and John Crane, CFTC Docket No. R 77-46, CFTC November 16, 1981. Like so many other cases with precedential value for future cases, the CFTC has not published its decisions nor has it complied an index so that parties in Reparations proceedings may retrieve rulings from earlier cases where an issue has been previously decided. Slip opinions may be obtained from the CFTC by using the full name and docket number.

In the case of Delphine Friedman v. Dean Witter & Co. and John Crane, ("Friedman"), the CFTC quoted the 1974 Report of the House Committee on Agriculture:

> Counterclaims will be recognized in the proceedings but on such terms and under such circumstances as the Commission may prescribe by regulation. It is the intent of the Committee that the Commission will promulgate appropriate regulations to implement this section.

H.R. Rep. No. 93-975, p. 23.

The CFTC said that pursuant to this authorization under Section 14, the Commission adopted Rule 12.23(b)(2), which provides:

> An answer may set forth as a counterclaim facts alleging a violation and a request for a reparation award that would be a proper subject for a complaint under §12.21 or any claim which at the time the complaint is served the registrant has against the complainant if it arises out of the transaction or occurrence or series of transactions or occurrences set forth in the complaint.

41 Fed. Reg. 3995 (January 27, 1976).

Finally on November 16, 1981, the CFTC issued the Friedman decision wherein the Commission stated unequivocally that they had the authority to adjudicate and award counterclaims. See Friedman, p. 10.

So why is the CFTC now asking for a statutory amendment which would authorize the CFTC to adjudicate counter claims? This new CFTC proposal is merely a smoke screen and there is no guarantee that the CFTC won't ignore this new format any more than the directives given by Congress during the 1974 and 1978 Hearings.

The only area to be really affected by the proposed CFTC amendment would be the area of hearings. At present the statute requires the CFTC to conduct hearings in accord with the Administrative Procedures Act, 5 U.S.C. §551 et seq ("APA"). The APA is another statute enacted by Congress which provides standards and guidelines to be used by the administrative agencies within the Executive Branch. The APA is merely a distillation of fairness and due process as the result of over 100 years experience with such hearings. The CFTC wants to be "relieved of the cumbersome requirements" of the APA. The only cumbersome requirement is that a party have an opportunity to present his case in writing before an ALJ makes a decision. Under the present system the CFTC gives the parties 30 days after the trial for such submission or 15 days after an initial decision in the case of an appeal. This is not what is causing the Commision to delay three to four years in processing each case.

Before Congress gives the CFTC its "blank check" there should be some need shown for modification of a system which would take away the due process safeguards of the APA.

To explain the reasons for the delays, one need only look at the aging charts provided in the six audits of the Reparations program (see Footnote 3 for a list of those audits). In 1977 the auditor stated that a delay of 126 days between the filing of a complaint and the assignment of an ALJ was "unacceptable." The Commission has done nothing to correct this problem.

Subsequent experience shows that by 1979 - in spite of the the auditor's warnings - that delay had increased to an average of 373 days. The following is an aging chart pinpointing where the delays are occurring:

Average Number of Days to Process Cases

Fiscal Year(a)	1976	1977	1978	1979	1980	1981
Average number of days from filing a complaint to docketing the complaint	67	100	247	194	135	119
Average number of days from docketing to assignment of an ALJ	42	70	160	373	289	100
Average number of days from assignment of an ALJ to adjudication	422	366	438	222	76	63
Average number of days from notice of appeal to decision by CFTC granting or denying an appeal	410	294	158	(b)	(b)	

If an appeal is granted, the average number of days until the CFTC renders a final decision	788	343	126	(b)	(b)
Total average number of days	1,729	1,173	1,129	(b)	(b)

(a) These statistics were developed by the CFTC. For example it took an average of 1729 days (almost 5 years) to dispose of Reparations complaints filed in February 1976.

(b) According to CFTC officials who prepared this data, the Opinions Section has not yet disposed of enough cases in these categories to develop accurate statistics.

There is nothing magic about assigning a case to a judge. In almost all forums, a judge is assigned on the day a Complaint is filed. Almost all courts assign judges on a system of rotation or lottery. There is no reason for the CFTC to delay 373 days for this ministerial act.

There has only been one study of the CFTC's Reparations program which concerns the actual procedures and how they interact with the CEA and the APA. That study is by CFTC ALJ Arthur Shipe and it has been published in the 1981 Administrative Law Review.7/ More than any brochure published by the Commission or the CFTC's Rules of Practice for Reparations proceedings, the Shipe article explains how and why the system operates.

Finally, turning to the CFTC request for authority to promulgate rules for Motion Practice in Reparations proceedings, this is another area over which the Commission already has plenary power. Motions could easily be heard and decided by the ALJ's as soon as a complaint is filed or docketed. However the Commission by opinion, has issued a decision which strips the ALJ's of their power to rule on Motions.8/ The Commission has determined that the Complaints Section has the power to institute Reparations proceedings and once they are

---

7/ Shipe, A. Private Litigation Before the Commodity Futures Trading Commission, 33 Ad. L. Rev. 153 (Winter 1981).

8/ Antoniolli v. Clayton Brokerage Co. of St. Louis, CCH Com. Fut. L. Rep. ¶20,546 (CFTC January 18, 1978).

forwarded for docketing, they cannot be summarily dispensed with. The reason for this is that the statute at Section 14(a) and (b) refers to the Commission rendering "an opinion" on the complaints before hearing. Furthermore, under the present 14(b) the statute requires the Commission to investigate before the matter is "served" upon a respondent and before a hearing is conducted.

The Antoniolli decision pre-supposes that the Complaints Section is undertaking an extensive investigation when in fact no such investigation has been conducted. Ever since commencement of this program, the Commission has stated that the Complaints Section merely performs a "screening function." According to all audits, the Complaints Section reviews the complaint for jurisdictional purposes only. There is no attempt to become involved nor is there an active investigation. There is a sound rationale for this CFTC policy of not adhereing to the statute and that is, if the CFTC were to conduct an investigation of each case then the parties would require this CFTC investigator to appear as an expert witness to give testimony. Furthermore, each party would also demand the right to challenge or cross-examine the investigator. The CFTC staff members would find themselves constantly involved as witnesses in the 400 or so Reparations trials conducted each year.

The CFTC has wisely determined that complaints may only be "investigated" by the parties themselves and with the limited discovery procedures pursuant to the CFTC's rules of practice, the investigation rarely takes place until the day of the hearing when the ALJ acts as a referee to each side posing questions. The APA at 5 U.S.C. §554(d) provides that only Title 5 hearing examiners may receive and review evidence. The Complaints Section cannot perform an extensive investigation if the Commission and its staff wish to remain a non-involved neutral in the Reparations proceeding.

Even though the Hearings office is a separate section within the CFTC, this "Chinese Wall" does not completely preclude intervention from other offices within the Commission. During the course of pre-trial discovery, complainants often consult with members of the CFTC staff - especially in divisions not responsible for the reparations process. The dual purpose of the CFTC - that of enforcing the CEA and of conducting an impartial reparations forum - is often indistinguishable and the staff has taken actions which discourage settlements and encourage the prolongation of broker-customer litigation.

Reparations complainants often are the very individuals who served as CFTC witnesses during an Enforcement proceeding. Complainants incorrectly assume the ALJ's will take cognizance of the information as developed in the Enforcement proceeding and "rubber stamp" all claims against these firms. All too often pro se litigants arrive at trial expecting that an attorney from the Enforcement Division will represent the private customer's interest. As previously noted in the 1978 GAO report, the CFTC provides no brochure to the public to clarify these fairly standard misconceptions.

Conclusion

If Congress determines that the CFTC should be reauthorized, the then CFTC should continue to perform its Reparations program. As for statutory changes, very little is required. Congress, not the CFTC, should determine whether the CFTC is to become a participant in each Reparations proceeding or whether the CFTC merely provides a forum. If the CFTC is to continue as an adjudicator of claims, then the APA safeguards are needed. If on the otherhand, Congress determines that the CFTC is to become a participant in each case, then there must be a lower threshold for judicial review rather than the United States Courts of Appeals. If the CFTC is to become involved in these claims and if the Commission is to have a vested interest in the outcome of each decision based upon its own evidence and testimony, then Congress should provide for trial de novo before the United States District Courts.

The failures of the CFTC's Reparations program stem not from the statute; rather the reflect poor administration by the agency. With proper attention from the Commission the CFTC's Reparations program could become a forum of expertise involving not only commodity disputes but also serve as a model for a forum involving securities matters as well.

TESTIMONY OF LOUIS E. CARABINI
PRESIDENT OF MONEX INTERNATIONAL, LTD.

PRESENTED TO THE SUBCOMMITTEE ON AGRICULTURE
RESEARCH AND GENERAL LEGISLATION
OF THE SENATE COMMITTEE ON AGRICULTURE,
NUTRITION, AND FORESTRY

MARCH 11, 1982

Introduction

Good morning, Mr. Chairman and members of the Committee. My name is Louis E. Carabini. I am the President and Chairman of the Board of Directors of Monex International, Ltd.

Monex' principal activity is the purchase from and sale to private individuals of precious metals, primarily gold and silver bullion and bulk gold and silver coins, both on a cash basis and pursuant to contracts commonly known as leverage contracts. Since its organization in 1967, Monex has engaged in over $7 billion of such commodity transactions with more than 70,000 customers and has grown into one of the world's largest suppliers of precious metals to private individuals. The company currently has over 10,000 active customer accounts.

Leverage Contracts

A leverage contract is defined in Section 19 of the Commodity Exchange Act as a standardized contract for the delivery of a commodity "commonly known to the trade as a margin account, margin contract, leverage account, or leverage contract." However, leverage contracts have been known by many other names. Indeed, they have been described in testimony before Congress as, among other things, "forward commodity contracts," "leveraged commodity purchase accounts," "forward contracts," contingent or installment sales, "commodity forward contracts," a form or type of contract for future delivery of a commodity, "contracts for forward delivery of . . . commodities," "purchases on the installment plan," and standardized long term forward contracts.

In short, a leverage contract is best described as a standardized agreement for the purchase from or sale to a member of the general public of a specified commodity in a standard unit and quality for delivery at any time upon payment in full. The principal characteristics of leverage contracts include: (1) standard units, quality, and terms and conditions; (2) payment and maintenance of margin; (3) payment of carrying or leverage charges on the unpaid balance of the purchase price under the contract, which payments may vary and be paid periodically, or be fixed in advance and prepaid for all or a portion of the term of the contract; (4) close-out by an offsetting transaction or by delivery, after payment in full; and (5) no right or interest in a specific lot of the underlying commodity until delivery. The leverage dealer is the principal to every such transaction and functions as a market maker. Leverage dealers cover their obligations to their customers by maintaining physical inventories and by engaging in transactions in the cash forward and futures markets. Currently and historically, Monex has covered the majority of its obligations to its customers with physical inventories.

Leverage contracts are perhaps best understood by reviewing the history of their development, which is, in large part, a review of the history of Monex. Monex was originally founded as a small coin shop in Long Beach, California. In response to the demands of our customers, the company began to sell bags of silver coins to the public on a cash basis. At that time, the value of the silver content of a bag of bulk United States silver coins was greater than the face value of those coins. Accordingly, the maximum amount a customer's investment in a bag of silver coins could decline was the difference between the face value of the coins and the value of the coins' silver content. This enabled our customers to finance their purchases by borrowing the face value of the coins from banks and pledging the coins as security for their loans.

As the demand of our customers for silver coins grew, such financing arrangements became an increasingly popular method of purchasing silver coins from Monex. However, most commercial banks and other financing institutions were (and still are) ill-equipped to take physical possession of a bag of silver coins (the only way under state law to protect a security interest in a bag of United States coins), and for this reason it sometimes proved difficult for Monex' customers to obtain the financing they desired. As a result, as Monex grew it began to extend credit directly to its customers. At about the same time, Monex also began to repurchase bags of coins from its customers, thereby providing them with a ready two-way market place in which they could conveniently sell their precious metals investments without incurring the inconvenience of finding a retail precious metals dealer willing to purchase their coins and without being forced to suffer the substantial discounts imposed by many such retail dealers. With these innovations in Monex' business, the modern leverage contract was born.

The "Regulation" of Leverage Transactions by the CFTC

The Commodity Futures Trading Commission was first given jurisdiction to regulate leverage transactions by Section 217 of the Commodity Futures Trading Commission Act of 1974. Both the Conference Report and the Senate Committee Report on the 1974 Act made it clear that Section 217 "require[d] the Commission to regulate transactions for the delivery of silver bullion, gold bullion, or bulk silver coins or bulk gold coins." Nonetheless, the only rule adopted by the Commission with respect to leverage transactions in the first three and one half years of its existence was a general anti-fraud rule. This was in spite of the fact that a special Advisory Committee which the Commission had created to advise it with regard to leverage transactions had submitted a report to the Commission in 1976 recommending the regulation of leverage transactions and the specific manner in which such regulation should be accomplished.

Having made no real attempt to regulate leverage transactions, the Commission asked Congress, in the 1978 reauthorization process, to relieve it of its jurisdiction over the area by repealing Section 217. This recommendation was made by the Commission with full knowledge that the repeal of Section 217 would have resulted in a regulatory vacuum which the federal and state securities administrators undoubtedly would have attempted to fill. Although leverage transactions are not, and can not be treated as securities, the resulting litigation over that issue would quite possibly have destroyed the leverage industry.

When questioned in Congressional hearings regarding the Commission's recommendation, the Vice Chairman of the agency explained that he believed the recommendation was the result of a judgment by the Commission that "leverage was not worth the trouble we were going through in trying to define it. Therefore, I think we are coming back to you and asking you to take us off the hook." In other words, the Commission was asking Congress to relieve it of its responsibility to regulate the leverage industry simply because the agency did not want to be bothered with doing so. That recommendation was made despite the fact that the Commission had never made any attempt to regulate the leverage industry and with the knowledge that if Congress did follow the Commission's recommendation, it might well result in the total destruction of the industry. In short, for purposes of its own regulatory convenience, the Commission would have destroyed a legitimate economic activity in which tens of thousands of American citizens participate each year and deprived the American public of a vehicle through which they can protect themselves against the effects of inflation and other adverse economic conditions.

As you are aware, Congress did not follow the Commission's recommendations in 1978. Instead, it expanded the CFTC's jurisdiction to include leverage transactions involving all commodities but the traditional domestic agricultural commodities. Moreover, the Conference Report on the Futures Trading Act of 1978 made it quite clear what the Commission's responsibilities were with respect to leverage transactions:

> "It is the intent of the conferees that the Commission act expeditiously upon enactment of the conference substitute to regulate under new section 19(b) of the act leverage transactions in gold or silver bullion or bulk coins under appropriate regulatory standards to insure the financial solvency of such transactions and prevent manipulation or fraud."

Despite this reaffirmation of Congressional intent, the Commission has continued to shirk its responsibilities, even to this day. Shortly after the passage of the Futures Trading Act of 1978, the Commission proposed and later announced its intention to make a determination with respect to leverage transactions, the nature of which I will shortly discuss, which would have the effect of banning all leverage transactions. That determination was to take effect on January 1, 1980. In response to Congressional expressions of concern over the proposed action, the Commission postponed the announced effective date of its action first to June 30, 1980 and then later to October 1, 1982, allegedly to obtain further Congressional guidance on the leverage issue, as if any such further guidance were necessary.

At roughly the same time as the Commission announced its intention to ban the entire leverage industry, it adopted moratoriums prohibiting the entry of further firms into that business. Those moratoriums remain in effect today, thereby preventing the development and growth of a legitimate business enterprise.

Leverage Contracts versus Futures

It was shortly after the conference committee finished its deliberations on the Futures Trading Act of 1978, but, fortunately, prior to the issuance of the Conference Report, that the Commission for the first time publicly considered whether it should determine that all leverage transactions are futures contracts and should be treated accordingly. Since, under the Commodity Exchange Act, all futures contracts must be traded through a member of a designated contract market, and since leverage contracts cannot by their very nature be traded on a contract market, the effect of such a determination would be the destruction of the leverage industry. Even though the Conference Committee Report on the then pending Futures Trading Act of 1978 had not as yet been issued, the Commission voted to publish for public comment a Commission memorandum advocating such determination.

When the conferees were informed of the Commission's intended action, their response was immediate. It may be found in the Conference Committee Report on the Futures Trading Act of 1978:

> "The conferees did not contemplate, based upon prior representations by the Commission, that the Commission would classify all gold and silver leverage contracts as contracts for future delivery. Therefore, the conferees expect that the Commission will not take final action on the recommendation contained in the memorandum until the Committee on Agriculture, Nutrition, and Forestry of the Senate and the House Committee on Agriculture have an opportunity to receive testimony on this issue."

As I have previously recounted, despite this clear expression of Congressional intent, the Commission nonetheless proceeded only a few months later to propose and then announce its intention to adopt the determination without giving Congress the opportunity to hear testimony on the issue as the conferees on the 1978 Act had asked.

The assertion that leverage contracts are futures contracts is but another attempt by the Commission to free itself, for purposes of its own regulatory convenience, of the responsibility of regulating a legitimate business activity. Leverage transactions clearly are not futures contracts. The differences between the two types of contracts are numerous and varied and exceed by several times the similarities between the two types of contracts. The two instruments differ significantly in, among other things: duration, both in practice and under their contractual terms; size; delivery terms; the nature of the initial payment made with respect to each (a down payment in the case of the leverage contract versus the margin or earnest money deposit in the case of the futures contract); the frequency, or in the case of the leverage contract, the infrequency, with which calls for additional monies are made; the pricing mechanism for each instrument; the commodities offered pursuant to each instrument; the parties to each instrument; the purposes for which each instrument is used; and the historical development of each.

Leverage transactions essentially involve the purchase of commodities at the current spot or cash market price and the payment of a leverage fee on the unpaid balance of the price at which such commodities are purchased. Futures do not. Leverage dealers issue firm price quotations to their customers, which are of course unavailable with futures, and offer expanded trading hours over those available with futures. There are no locked markets or limit moves in the leverage area, as there are with futures. Delivery under a leverage contract is made promptly upon demand at any time during the life of the contract upon payment in full of the remaining balance due, and at virtually any place within the United States, while delivery under a futures contract can only occur in the specified delivery month under the contract and only at a few designated delivery points. Moreover, deliveries occur in a much greater percentage of all leverage contracts than is the case with future contracts. And in certain commodities the percentage of deliveries under leverage contracts is quite substantial.

The primary economic justification for the existence of the futures markets is that they can be used as a mechanism for commercial hedging by producers, processors, refiners and other commercial enterprises. Futures contracts are specifically tailored to encourage this type of hedging activity, and one of the Commission's primary statutory responsibilities is to promote and insure such usage of the futures markets. In contrast, leverage transactions were not designed to be used by commercial enterprises as hedging vehicles or otherwise. Instead, they were specifically designed, as I have previously mentioned, to be utilized by individual investors, investors who for the most part wish to hold a portion of their wealth in assets with historical intrinsic value as protection against the effects of inflation and other adverse economic conditions.

Even a cursory examination of the differences between leverage contracts and futures which I have just described make it totally clear that the two are distinct and separate instruments. Indeed, because of differences such as these, the Commission's own Advisory Committee on Market Instruments (of which current Commission Chairman Philip Johnson was a member) concluded, as long ago as 1976, that leverage transactions are not futures and that the Commission should not treat them as such.

The Commission's Current Legislative Recommendations

The Commission has come before this Subcommittee and urged that it recommend to the Congress the statutory continuation of the moratoriums against entry into the leverage business which the Commission has imposed by regulation. The Commission has further recommended that the Congress direct it to conduct a two-year study of the leverage business to determine, among other things, whether leverage contracts are futures contracts, whether they should be prohibited, whether they should be regulated by another federal agency or by the various states, and how, if the Commission retains jurisdiction over leverage transactions, they should be regulated by the Commission. When such recommendations are viewed in the context of the Commission's overall actions in the leverage area, they can only be seen as another attempt by the Commission to avoid assuming its Congressionally mandated responsibilities.

The Commission's continuing refusal to regulate the leverage industry and its hostile attitude toward the industry have surrounded companies in the industry and their customers with a shroud of doubt and uncertainty. The difficulty in operating a business in such an atmosphere can hardly be overstated. The unjustified moratoriums which the Commission has imposed against the entry of new firms into the leverage business have served to intensify the pall over the industry. Now the Commission is asking Congress to sanctify those moratoriums by incorporating them into the Commodity Exchange Act. Such a request can only be termed unconscionable.

The Commission has had jurisdiction over the leverage industry for seven years. During that time it has had the benefit of at least three studies of the industry. In fact, in a 1978 letter to the Chairman of the Senate Committee on Agriculture, Nutrition, and Forestry, the Chairman of the Commission said, and I quote:

> "During the past three years, the Commission has studied and monitored the offer and sale of leverage contracts in gold and silver as well as the nature of the leverage contracts being offered to the public. Recently, the Commission staff completed an in-depth survey of the sales practices and financial stability of firms currently marketing leverage contracts." (Emphasis added.)

There has been little change in the industry since the Commission's most recent study was completed, in large part because the Commission's moratoriums have prevented new firms from entering the business. Even if the Congress were to direct the Commission to conduct yet a fourth study of the leverage industry and to report the results of that study to Congress, it is highly unlikely that the Commission would be able to conduct, within the two years they have asked for, a study which would be more thorough or of any more value than those which have already been conducted.

In addition to the studies which have been made of the leverage industry, the Commission has also had the benefit of the experience of an advisory committee created specifically for the purpose of reporting to the Commission regarding, among other things, the leverage industry. That committee made specific recommendations to the Commission as to how leverage transactions should be regulated. (The Commission's staff was then directed to and did prepare draft regulations based on those recommendations. However, the Commission never published those draft rules for public comment.) Moreover, long frustrated by the Commission's repeated refusal to regulate the leverage industry, Monex and International Precious Metals Corporation, another major leverage firm, submitted an extensive joint rulemaking proposal to the Commission in early 1979 which contained a complete set of rules for the regulation of the leverage industry and an explanation of the bases for those rules.

The questions which the Commission proposes that its recommended study address have already been answered, and answered repeatedly. Indeed, many of them were answered by the Congress both in 1974 and again in 1978. Enough is enough. The Commission has sufficient knowledge of the leverage industry to adopt rules for its regulation and more than adequate resources to administer such rules. The Commission knows what its responsibilities are. It just doesn't want to assume those responsibilities.

Conclusion

The Commission has been directed by Congress on two separate occasions to regulate the leverage industry in a manner which would permit its continued existence. In response, the Commission has repeatedly shirked this responsibility, apparently for purposes primarily of regulatory convenience. I urge the Congress and this Subcommittee to refrain from giving the Commission yet another opportunity to shirk those responsibilities and ask that this Subcommittee recommend to the Congress that it reject the Commission's legislative recommendations in the leverage area and instead repeal that portion of Section 19 of the Commodity Exchange Act which permits the Commission to treat leverage contracts as futures and replace it with statutory provisions clearly and specifically directing the Commission to move expeditiously to adopt substantive and rational regulations for the leverage industry at its earliest opportunity.

I thank the Subcommittee for this opportunity to testify.

STATEMENT OF JAMES J. GROBERG
CHAIRMAN OF THE BOARD
INTERNATIONAL PRECIOUS METALS CORPORATION
BEFORE THE
SUBCOMMITTEE ON AGRICULTURAL RESEARCH AND GENERAL LEGISLATION
COMMITTEE ON AGRICULTURE, NUTRITION AND FORESTRY
UNITED STATES SENATE

March 11, 1982

Mr. Chairman and Members of the Committee, my name is James J. Groberg. I am Chairman of the Board of International Precious Metals Corporation and I thank you for the opportunity to present this testimony in connection with S.2109 and reauthorization of the Commodity Futures Trading Commission. IPMC is a wholly-owned subsidiary of MultiVest, Inc., a publicly-held company, with over 600 shareholders, whose subsidiaries are engaged in the real estate and commodities business.

IPMC was created in 1973 and is engaged in the sale to the public of precious metals through a transaction known as a "leverage contract". IPMC is located in Ft. Lauderdale, Florida. Our company currently employs 160 people, we have approximately 3,000 customers, and our 1981 gross sales totaled approximately 94.5 million dollars. The net worth of IPMC as of December 31, 1981 was 7.65 million dollars.

I appear today to express a deep sense of frustration. This is the third time in a span of eight years that IPMC has addressed Congress seeking nothing more than a settled regulatory atmosphere in which to conduct our business.

In 1974 Congress included within the charter of the new CFTC the regulation of companies engaged in the sale of commodities through leverage contracts. Section 217 prohibited any person from entering into a leverage transaction contrary to any CFTC regulation designed to ensure the financial solvency of the transaction or to prevent manipulation or fraud. The Conference report clearly directed the new CFTC to regulate these transactions.

Shortly after the CFTC was created in April 1975, it adopted a stop-gap antifraud regulation for leverage transactions. IPMC strongly supported this regulation and in comments to the CFTC urged in addition that the Commission "move swiftly to adopt additional comprehensive regulations under section 217".

The Record of the Commission's response to its section 217 obligations from then until now presents a case of abuse of authority and neglect of responsibility which defies belief.

On August 20, 1975 the CFTC proposed a temporary rule to regulate leverage transactions pending a more comprehensive review of the industry, but the proposal was never acted upon. In the meantime the CFTC empaneled a 17-man Advisory Committee to study and make recommendations on the Commission's jurisdiction over futures, forward and leverage contracts.

On July 16, 1976 the CFTC Advisory Committee on Market Instruments after almost a year of study, including several public hearings, published an exhaustive report including findings that leverage transactions are (a) distinct from traditional exchange-traded futures transactions and should not be regulated as such futures contracts, (b) are not inherently fraudulent or manipulative, and (c) could not and should not be prohibited. The Committee also proposed specific and comprehensive recommendations to the CFTC for leverage transaction regulations.

Shortly thereafter, on September 28, 1976 the CFTC's General Counsel endorsed the Advisory Committee findings and recommendations. The following week, on October 4, 1976, the CFTC considered the findings and voted to regulate leverage transactions in accordance with the recommendations of the Advisory Committee. At that meeting the Commission directed its staff to prepare regulations for publication.

But it was to be over a year before the subject would ever surface again. Finally, at a meeting held November 8, 1977 the CFTC discussed the status of the proposed regulations and decided more "study" of the leverage business was necessary in order to help the Commission draw a distinction between leverage contracts and futures contracts. The staff was directed to conduct the study and return to the Commission, "within four weeks". But no study was returned in four weeks.

In another three months, before the staff "study" was finished and in an abrupt reversal of its course, the CFTC asked this Committee to repeal section 217. The CFTC Vice Chairman, on February 21, 1978 summarized the Commission's position on reauthorization of the leverage authority saying, "Frankly, I think the judgment was made by the Commission that leverage was not worth the trouble we were going through in trying to define it. Therefore I think we are coming back to you and asking you to take us off the hook."

During that reauthorization IPMC and its major competitors asked Congress not to reopen the "regulatory gap" that had existed prior to 1974 by repealing section 217, but to direct the CFTC promptly to regulate. On August 17, 1978 House and Senate conferees rebuffed the Commission's proposal, agreed to expand its jurisdiction over leverage transactions involving all commodities, and directed the Commission once again to regulate. The draft Conference Report stated succinctly enough, "It is the intent of the conferees that the Commission act expeditiously . . . to regulate . . . leverage transactions in gold and silver."

Nevertheless, after the committee had adjourned but before the report had been adopted, and in a last minute effort to circumvent the action of the conferees, the Commission deliberately put Congress on notice that all leverage transactions could be banned by the CFTC utilizing its authority under proposed section 19(d) as an alternative to regulating the industry. This, they reasoned, would force Congress "to clarify" its intentions with respect to section 19.

In response, language was added to the Conference Report stating, "In this regard, the Commission's authority to determine that any gold or silver leverage contract is a contract for future delivery. . . is not to be casually exercized as a substitute for the regulation of that leverage contract. . . The conferees did not contemplate, based on prior representations by the Commission, that the Commission would classify all gold and silver leverage contracts as contracts for future delivery."

The Commission has failed to follow this instruction. First, on December 5, 1978 the CFTC took final action on a "temporary" moratorium on the entry of new firms into the gold and silver leverage transaction business. The "temporary" moratorium was made effective June 1, 1978. To this day the Commission has frozen the entry of new competition into our business. Shortly thereafter, on February 2, 1979, the CFTC imposed another "temporary" moratorium on the sale of any commodities other than gold or silver by either existing leverage firms or any new firms. This moratorium also remains in effect today, freezing even product competition among the few companies allowed to engage in the leverage business.

In a good faith effort to expedite the Commission's compliance with Congress' instruction to regulate, two major leverage firms, IPMC and Monex International, next submitted to the CFTC on February 14, 1979 a joint rulemaking petition including comprehensive leverage regulations. In March, notice of the proposed ban -- the determination that leverage contracts are futures contracts within the meaning of the Act -- was published. Subsequently, notice of the availability of the industry petition was published in April. The Commission has never acted upon the industry proposals. In the meantime, in spite of overwhelmingly negative comments received in response to the proposal that leverage contracts were actually futures contracts, the CFTC published notice on July 27, 1979 of its intention so to determine, effective January 1, 1980. The Commission without any consideration of the impact upon thousands of leverage customers, acknowledged that this action would constitute a ban on all leverage transactions.

Since it was apparent the Commission was still ignoring the instruction it had received, Chairman Talmadge and Senator Helms on behalf of the Senate Agriculture Committee, and Chairman Foley and Representatives Wampler, Jones and Madigan, on behalf of the House Committee on Agriculture, sent letters to the CFTC on November 15 and 16, 1979, respectively, reminding the Commission of its regulatory mandate under section 19, urging the Commission to reconsider its proposed ban, and warning the Commission against trying to impose its own deadline on Congress.

In response to this letter, the CFTC met on December 3, 1979 and voted to postpone the effective date of its proposed ban on leverage transactions until June 30, 1980. On May 28, 1980 the CFTC voted again to postpone its proposed ban, this time until October 1, 1982. Purportedly, this would give Congress yet another opportunity to clarify its intentions. It directed the staff to develop "interim" regulations to protect the public in the meantime.

These regulations were to be published and effective not later than December, 1980, but once again the staff failed to act. Then, at a meeting on April 28, 1981, almost a year later, the CFTC finally considered specific proposals for "interim" regulations. The Commission approved them and directed the staff to prepare a Federal Register notice publishing the specific regulations. These "interim" proposals have never been published.

In what can only be described as consistent with its record to date, the CFTC, in submitting its legislative recommendations, told this Committee that it needs yet another two years in order to study the nature of leverage transactions and the appropriate means of regulating this industry. It also asked that Congress ratify and extend its "temporary" anticompetitive moratoriums, thereby, of course, assuming responsibility for them.

With the utmost respect for and confidence in a CFTC Chairman and the new Commissioners who have inherited this record, I must nevertheless express a sense of frustration bordering on exasperation. The record may not belong to them personally, but it now belongs to them institutionally. In a few more months, another new Commissioner will inherit it; next Spring another. Between now and September 30, 1984 three of the five sitting Commissioners will be gone. Will their successors need more time to study our business? After eight years nothing could be more clear than that Congress must direct the CFTC, in the most absolute and unequivocal terms, to regulate this industry rather than continuing to pursue virtually every imaginable means to avoid doing so.

In the meantime our company, and of course our customers, have been plagued by an erratic and very costly abuse of the CFTC's responsibility over leverage transactions.

It has been impossible to conduct meaningful long-range corporate planning. Companies such as ours must be able to develop long-range strategy in order to service customers and compete successfully.

Our lawyers have felt it necessary constantly to demand updated disclosure to our customers of the possibility that the CFTC will ban leverage transactions. Of course, we have now had to revise the date of the proposed ban three times.

Our employees and their families have been subjected to a continuously shifting threat that their source of livelihood will be banned by the federal government.

Our industry has been frozen both in terms of new entrants and new products by moratoriums placed in effect solely for the regulatory convenience of the CFTC. A business axiom holds that a product or product format improvement can ultimately only be tested in the marketplace; but we are forbidden from attempting to improve our product. Because of the moratorium on new commodities, we cannot even compete with each other in commodities which one of us might have been selling February 2, 1979 that another company was not. IPMC sells copper; Monex and FNMC cannot. They sell platinum; we cannot.

There is nothing arcane about leverage contracts. They were introduced to Congress in 1974 -- in IPMC's testimony -- as "a form of contract for future delivery referred to as a 'leverage account'". By comparison, commercial metals dealers also sell gold and silver to their customers in a form of contract for future delivery commonly referred to as a spot or forward contract. As recognized then, and as remains the case today, neither of these forms of transactions constitute futures contracts "within the meaning of the Commodity Exchange Act". That phrase is of critical significance in that it specifically means "exchange-traded futures contracts", and by their very nature leverage contracts neither are nor possibly could be traded on an exchange. Indeed, we sell commodities which may be delivered in the future, but within the literal, everyday meaning of those words. A 1978 House Appropriations Committee study described leverage contracts as purchases of commodities on the installment plan.

Also in 1978, the Senate report on CFTC reauthorization legislation described a leverage transaction as "an agreement for the purchase or sale of a contract for the delivery at a later date of a specified commodity in a standard unit and quality, or the close-out of the contract by an off-setting transaction. The principle characteristics of the contract include: (1) standard units, quality, and terms and conditions; (2) payment and maintenance of "margin"; (3) close-out by an off-setting transaction or by delivery, after payment in full; and (4) no right or interest in a specific lot of the commodity. The leverage dealer is the principal to every transaction and functions as a market maker. The leverage dealer, however, does not guarantee a repurchase market and further reserves the right to cease operating as a market maker or broker for the customer." These are also some of the findings of the CFTC's own Advisory Committee, findings which are now over five years old.

It is apparent that Congress has now been ignored twice with respect to its direction to the CFTC that the agency regulate the leverage business. The CFTC for reasons which can be only described as expedient, has apparently chosen to continue to postpone acting on this regulatory mandate. In this instance we submit that the failure to have acted constitutes a serious abuse of the authority and responsibility granted by Congress. Failing to regulate the industry has resulted in all of the cost and uncertainty which I have just described, as well as the perpetuation of artificial barriers to entry -- all for want of an inclination on the part of the CFTC to regulate.

Sources at the Commission, itself, have suggested that the resource cost of regulating the leverage industry today would involve between only two and three staff-years. Using the Commission's own standard value of a staff-year at approximately $25,000, the amount involved would pale in comparison to the cost to the government of the delay and the studies and the continuous efforts to avoid its responsibility to this industry. The CFTC has forever complained of its need for more money and more people in order to perform its responsibilities. At the same time it has spent hundreds of thousands of dollars and probably several dozens of staff-years seeking to avoid performing its responsibilities under section 19. Putting aside the public cost of this government effort, the cost to the industry has been vastly in excess of $75,000 annually.

In addition to directing in absolute terms that the Commission should regulate this industry, we also respectfully suggest that Congress repeal section 19(d). The CFTC's record with respect to leverage transactions clearly indicates that the authority contained in section 19(d) has been misused as permissive authority to ban the industry. The CFTC staff proposed this use of section 19(d) literally before the ink had dried on the 1978 conference report. Notwithstanding the subsequent warning contained in that report, the Commission nevertheless pushed forward with its proposed ban.

Naturally, we applaud the recent action of the Commission in rescinding the proposed ban. But at the same time we remain gravely concerned that their action does not repudiate the notion that section 19(d) can be used to ban leverage transactions entirely. Instead, they appear to want to retain the apparent authority to ban while they undertake yet another redundant evaluation of whether leverage contracts might be futures contracts which should be traded on an exchange.

Furthermore the original purpose of section 19(d) has long since been mooted by the adoption of the CFTC moratoriums on new companies and commodities. The purpose of section 19(d) was ostensibly to enable the Commission to keep certain people from dodging appropriate regulation as a futures exchange by shielding their transactions behind a denomination of "leverage contracts". No one can enter the leverage business, however, so there is no such possible shield to be used. More fundamentally, however, if the CFTC were to regulate leverage merchants, then of course it could define and maintain control over those who entered this business in the first place. Thus, there is no need for separate special leverage transaction authority to be used to pierce a defense that a particular bucket shop might be selling commodities through "leverage contracts".

Finally we suggest that Congress reject the Commission's proposal to conduct yet another study of whether and how it should regulate the leverage business. I am a businessman, and I may not understand all of the subtleties of government processes. At the same time, however, I know that the classic escape for a corporate officer or government official who does not want to do something is to study it for awhile.

In light of the record I am afraid this "study" is little more than another evasion of responsibility. The issues have been studied as thoroughly as any other question the agency has ever considered. Thousands upon thousands of dollars were spent supporting an Advisory Committee which reached specific and straightforward conclusions on the issues which the Commission now proposes to review yet another time. The 1978 CFTC reauthorization testimony contains statements by every CFTC Commissioner that the Commission was continuing "to study the leverage issue". In 1977, instead of adopting regulations earlier directed to be prepared, the Commission postponed consideration and directed the staff "to study the leverage industry".

After witnessing the Commission's confusing behavior in 1978, IPMC retained at its own significant expense the services of an eminent specialist in the economics of commodities transactions, Dr. Roger Gray of Stanford University. We insisted that he independently evaluate the nature of IPMC's leverage transactions, and that whatever data he desired would be available to him. The results of his study were submitted to the CFTC, and although we have also submitted the study to congressional committees in the past, it is attached as an exhibit to this statement for your reference. In economic terms involving both their characteristics and their usefulness, Dr. Gray distinguished IPMC's leverage transactions from the futures contracts traded on organized exchanges. The results remain as valid today as then.

Going beyond the question of whether yet another study is needed, it should be rejected as an affront to Congress, itself. The CFTC is proposing that Congress formally ratify two more years of delay and inaction with respect to this industry, its employees and its customers. It has also asked Congress to take responsibility for extending its "temporary" anticompetitive moratoriums. Presumably, in two more years the Commission would bring the results of its study back to your doorstep. It would then be nine years since the Commission had first been directed to regulate the leverage business.

Throughout this period of delay and neglect, I believe this industry has clearly demonstrated that its products are useful, and that it is very mindful of its obligations to public customers. For example, in the absence of any CFTC regulation, IPMC has voluntarily --

-- Registered with the CFTC as a Commodity Trading Advisor;
-- Required its account executives to register with the CFTC as associated persons;
-- Required its account executives to complete a thorough company training program and to pass the National Commodities Futures Exam administered by the National Association of Securities Dealers;
-- Absolutely prohibited "cold-call" sales;
-- Adopted and enforced strict customer suitability standards;
-- Maintained a full-time compliance staff and an internal compliance program equal to if not better than any program in the securities or commodities industry;
-- Provided all prospective customers with a comprehensive risk and fee disclosure statement;
-- Scrupulously avoided the sale of "naked" contracts by fully hedging its obligations to customers in futures contracts, forward contracts with only the most reputable independent metals dealers, or storage of the actual commodity; and
-- Continuously maintained customer equities and coverage in special segregated accounts held exclusively for the benefit of customers.

In conclusion, as I have suggested earlier, although encouraged by the actions recently taken by the CFTC under Chairman Johnson's leadership, we feel we must nevertheless, after eight years of delay, ask Congress for a third time to direct the CFTC to act affirmatively with meaningful regulations to govern our industry.

There is something terribly wrong when civil servants not wanting to oversee this completely proper and lawful business can possess the apparent power to ban it as an expedient regulatory alternative. That is not the way government in this country works, and I beseech you to make that clear to the CFTC.

Our request is extraordinarily simple: let us conduct our business in a settled regulatory atmosphere and within a uniform, reasonable and appropriate set of standards.

STATEMENT OF DAVID F. SIMON, GENERAL COUNSEL,
FIRST NATIONAL MONETARY CORPORATION

Mr. Chairman and members of the Subcommittee, my name is David F. Simon and I am a member of the law firm of Simon, Deitch, Siefman and Tucker of Southfield, Michigan. I am general counsel for First National Monetary Corporation and a member of its Board of Directors. I thank the Subcommittee for the opportunity to appear before you to address several areas of concern in the proposed Futures Trading Act of 1982, S.2109.

First National Monetary Corporation was formed in 1977, to engage in the sale to the public of certain precious metals, on a cash and leverage contract basis. First National has been, since its inception, and continues to be, registered with the Commission as a Commodity Trading Advisor.

First National is one of the leading leverage transaction dealers having its prinicpal headquarters in Southfield, Michigan, with four additional branch offices in New York City, Miami, Dallas and Irvine, California. First National employs in excess of 290 persons throughout the country. We have requested this time to testify before this Subcommittee so that we might address a few of the important aspects of S.2109 which impact upon the leverage industry and the public at large.

Since the Company's formation in 1977, we have observed, as the members of this Subcommittee have also, a marked increase in the public's awareness and acceptance of the role played by commodities trading as an investment tool. Individuals desiring to maintain a portion of their savings in assets with historical intrinsic value have been purchasing gold, silver and other commodities as protection against inflation.

Mr. Chairman, I would like at the outset of my testimony to say that even though we may propose some suggested changes in S.2109, we do not in any way wish to imply criticism of Chairman Johnson. While we have not agreed with him on every issue before the CFTC, there are important aspects of the Commission's proposals we support and we do believe that he is truly an outstanding and knowledgeable Chairman, and we look forward to working with him and his fellow Commissioners during the coming months and years. I understand that he personally put a great deal of thought, time and effort into the proposed changes to the Commodity Exchange Act, and I would like to publicly commend him for presenting to the Congress a very thoughtful legislative proposal.

Mr. Chairman, there are, however, a few areas of the proposed legislation involving the regulation of leverage transactions that I would like to address.

As you know, in 1974 members of the leverage industry came to Washington, in the absence of any regulatory policy affecting leverage trading, to seek federal regulation of cur industry. Congress responded by the passage of legislation granting the CFTC exclusive jurisdiction to regulate leverage trading. In 1978, during the first reauthorization hearings, the Senate again addressed the issue of regulating leverage trading. In 1982 we have returned to Congress once again to sound the clarion call for reasonable uniform regulation. Almost eight years have passed since the issue of leverage trading regulation first surfaced. Then, as now, we seek a clear enunciation of federal policy affecting leverage trading. Without such clarity the leverage industry will continue to suffer in the vacuum of non-regulation.

Since 1974, however, several CFTC studies of the leverage industry have been conducted. Input from members of the industry has been sought -- and provided by several of the leading companies within the leverage industry -- including First National. Draft regulations have been prepared -- but not implemented. In short, no comprehensive federal regulatory scheme exists today.

It is against this backdrop that we offer our comments on S.2109 as it pertains to leverage trading. Briefly, we have the following recommendations:

1. The new legislation should mandate that the Commission adopt forthwith a permanent regulatory scheme for leverage trading. The proposed two-year study by the Commission would continue for two more years the uncertainty and regulatory vacuum in which all forms of leverage trading have existed to date. It would also allow for a finding that certain or all leverage trading may be deemed a futures contract and, consequently, that trading therein should be banned. We believe such a conclusion -- based wholly on administrative expediency -- would be a very poor substitute for regulation and clearly contrary to the 1976 Report of the Advisory Committee on Market Instruments to the Commodity Futures Trading Commission, as well as the previously expressed withses of the Congress. Therefore, the study proposed in Section 25 of S.2109 should be eliminated and Congress should direct the adoption by the Commission of uniform leverage trading regulation. It is essential that the regulatory scheme be administered by the CFTC, which has the requisite commodities expertise, rather than any other federal agency or the individual states. Suggestions that the 50 states separately regulate this industry, or any other segment of the recognized commodities industry, are ill-founded since such a result would only create confusion, costly duplication, conflicting standards of regulation or the complete absence thereof in the event any states might fail to act in this area. However, proposals that the states participate in the enforcement aspect of federal commodity laws are sound; and we support these proposals.

2. Current Section 19(d) of the Commodity Exchange Act should be eliminated in its entirety. S.2109 leaves intact the provisions of Section 19(d), which allow the Commission to effectively ban all forms of leverage trading. At best, its language is inconsistent with the legislative history underlying the 1978 amendments to the 1974 Act and Congressional intent as expressed in various correspondence to the Commission from members of the Senate Committee on Agricultue, Nutrition and Forestry, and other members of Congress. In this respect, Section 19(d) has been used by the Commission as a means to circumvent the intent of Congress. Moreover, if new legislation does mandate regulation as we suggest, there would appear to be no need for Section 19(d); particularly in light of existing moratoriums preventing new firms from entering the leverage business. Indeed, once uniform regulations have been promulgated, the moratoriums should be lifted so that the leverage industry may be allowed to grow normally and other firms permitted to enter the business upon demonstrating their ability to comply with the pertinent regulations.

In making our recommendations I am mindful of the confusion which has been created by the lack of sufficient definitional clarity or benchmarks to guide this industry, the Commission and the courts in adequately describing a leverage contract. Indeed, the Commission's own Chief Administrative Law Judge, Eugene E. Hunt, has stated that the confusion of terms relating to off-exchange instruments arises from the lack of definitional clarity in the Commodity Exchange Act, itself. We agree. All of the regulations in the world will be of little benefit if the scope of what is being regulated is not adequately understood. The essential elements of a leverage contract include: (1) standard units, quality and terms and conditions; (2) payment and maintenance of "margin"; (3) the payment of carrying charges on the unpaid balance of the purchase price, which carrying charges may be paid periodically or fixed in advance and prepaid for the term of the contract; (4) the ability of the customer to make or take delivery at any time during the contract term after payment in full; and (5) no right or interest in a specific lot of the underlying contract until delivery.

In understanding our recommendations it is helpful to look back at the past eight years. The history of leverage contract regulation has been marked by two divergent paths; one path taken by Congress and the other by the Commission.

The Congressional path began with enactment of Section 217 of the Commodity Futures Trading Commission Act of 1974; providing for the first time for federal recognition of leverage transactions. The Futures Trading Act of 1978 replaced Section 217 with Section 19 and used broader language to describe leverage contracts. The 1978 Amendment authorized the Commission to regulate leverage trading in gold and silver bullion and bulk coins. The Joint Explanatory Statement of the Committee of Conference stated:

> It is the intent of the Conferees that the Commission act expeditiously upon an enactment of the Conference substitute to regulate under Section 19(b) of the Act leverage transactions in gold and silver bullion or bulk coins under appropriate regulatory standards to insure the financial solvency of such transactions and prevent fraud.
>
> In this regard, the Commission's authority to determine that any gold or silver leverage contract is a contract for future delivery and to treat such transactions as such is not to be casually exercised as a substitute for the regulation of that leverage contract. On other occasions, the House Agriculture Committee, together with the Senate Agriculture Committee, has written to the Commission asking it to postpone determining that leverage contracts are future contracts in light of Congress' position with respect to regulation.

Subsequently, in 1979, after being advised that the Commission was seeking to effectively ban all leverage business, the Chairman of the Senate Committee on Agriculture, Nutrition and Forestry, and the ranking minority member, wrote the Commission asking for a delay of any ban and expressing concern "...over proposed action by the Commission appearing to legislate on a question that Congress has already resolved in favor of substantive regulation." (See Attachment.)

On the other hand, notwithstanding the clearly spoken intent of Congress that leverage transactions be regulated, the history of action taken by the Commission with respect to leverage contracts is replete with actions designed to effectuate their outright prohibition. Since 1975 the Commission has only passed regulations pertaining to anti-fraud and two moratoriums restricting new entry into the leverage business. It has not, however, adopted any substantive proposals for regulation of this industry, despite repeated requests from members of the industry, including First National, that such action be taken, consistent with the public interest to be served thereby. Rather, the Commission has adhered to the administratively expedient position that leverage transactions are contracts for future delivery. The Commission's position has been expressed in the form of official Commission action, administrative enforcement proceedings designed to interpret the meaning of "leverage contracts" and in its public policy statements.

Returning to our recommendations, I would like to focus on our concerns as they relate to the public's interests.

First, in recommending that the language of proposed Section 19(e), which would require a study of the leverage industry, be stricken and in its place a mandate for federal regulation be stated, we believe that such action will benefit the many thousands of existing leverage customers by continuing their ability to trade on a leverage basis and, fianlly, establishing uniform guidelines upon which the investing public can rely. It has been said that the nature of leverage trading, in its various forms, predates the formation of the Commission. In 1976, the CFTC commissioned an Advisory Committee to study leverage trading and issue recommendations as to its regulatory treatment. A detailed report of the Advisory Committee provided, in part, that leverage contracts were not futures contracts and that they should be separately regulated. The Report set forth a clear and detailed regulatory scheme. My client and others in the leverage industry have asked for comprehensive regulations and submitted substantive regulatory proposals to the Commission designed to assure the financial solvency of leverage trading and protect the public interest. We continue to seek this result in these proceedings.

Second, we have asked for the elimination of Section 19(d). Its provisions have long served to cloud the regulation issue since it allows for action by the Commission contradictory to the expressed intent of Congress. Certainly if new legislation is enacted which mandates regulation of leverage transactions, then as a natural consequence thereof the potentially conflicting language of Section 19(d) should be eliminated.

The issues which I have raised here are not unique or new to the Subcommittee or the Commission. Indeed, the very fact that many of these points have continually been the subject of much attention is the reason they deserve to be finally resolved in 1982. The Commission is an ever-changing regulatory body, whose members and staff do not enjoy life tenure. As a result, changes at the Commission may be expected to continue to bring about policy shifts which will forever keep the leverage industry in a state of non-regulatory limbo. The leverage industry provides an important method by which individuals may purchase certain precious metals as a means of protecting against inflation. There is every reason to believe that the important role played by the leverage industry will increase in these inflationary times which threaten to engulf us all. The balance between industry concerns for clarity of regulation and the public protection to be afforded thereby present a strong imperative for the implementation of responsible and clear regulations rather than continued delay and ambiguity.

Again, thank you for the opportunity to appear and make known our views on this important subject.

ATTACHMENT

HERMAN E. TALMADGE, GA., CHAIRMAN

GEORGE MC GOVERN, S. DAK.
WALTER D. HUDDLESTON, KY.
RICHARD B. STONE, FLA.
PATRICK J. LEAHY, VT.
EDWARD ZORINSKY, NEBR.
JOHN MELCHER, MONT.
DONALD W. STEWART, ALA.
DAVID H. PRYOR, ARK.
DAVID L. BOREN, OKLA.

JESSE HELMS, N.C.
MILTON R. YOUNG, N. DAK.
BOB DOLE, KANS.
S. I. HAYAKAWA, CALIF.
RICHARD G. LUGAR, IND.
THAD COCHRAN, MISS.
RUDY BOSCHWITZ, MINN.
ROGER W. JEPSEN, IOWA

United States Senate

COMMITTEE ON
AGRICULTURE, NUTRITION, AND FORESTRY
WASHINGTON, D.C. 20510

November 15, 1979

Honorable James M. Stone
Chairman
Commodity Futures Trading Commission
Washington, D.C. 20581

Dear Mr. Chairman:

Thank you for your letter informing us of the Commission's intention to determine, effective January 1, 1980, that gold and silver leverage transactions are contracts for future delivery within the meaning of the Commodity Exchange Act. You and other members of the Commission have stated that the effect of this action will be to ban the leverage business as of January 1.

We wish to advise you that the Commission's decision is the cause of serious concern to us and other members of the Committee. We are particularly concerned with action by the Commission that would ban an otherwise lawful business--a business that predated the existence of the Commission--without the Commission's ever attempting to regulate it meaningfully.

Congress devoted considerable attention to leverage transactions during the 1978 reauthorization process. Our intent with respect to these transactions is set forth in the Act and in the conference report on the Futures Trading Act of 1978, which states, in pertinent part, as follows:

> It is the intent of the conferees that the Commission act expeditiously upon enactment of the conference substitute to regulate under new section 19(b) of the act leverage transactions in gold or silver bullion or bulk coins under appropriate regulatory standards to insure the financial solvency of such transactions and prevent manipulation or fraud.
>
> In this regard, the Commission's authority to determine that any gold or silver leverage contract is a contract for future delivery and to treat that transaction as such is not to be casually exercised as a substitute for the regulation of that leverage contract.

The conference report went on to state that "the conferees did not contemplate, based on prior representations by the Commission, that the Commission would classify all gold and silver leverage contracts as contracts for future delivery."

In the 1978 Act, Congress expanded and strengthened the basic authority of the Commission to regulate the leverage business. We did so despite the Commission's request to be relieved of this responsibility. In light of the attention that Congress gave to the issue of leverage contract regulation and the legislative history created in the passage of the 1974 and 1978 Acts, we are especially concerned over proposed action by the Commission appearing to legislate on a question that Congress has already resolved in favor of substantive regulation.

Congress created the Commission to protect the public interest in the commodities area. However, your letter states, in effect, the Commission's intention to prohibit a substantial area of ongoing economic activity. Such action could cause irreparable harm not only to the affected firms and their employees, but to their thousands of public customers as well. The Commission's January 1 ban of this business appears to be based on the Commission's own regulatory convenience--the very worst kind of overregulation.

Your letter states the Commission's intent to go forward with its determination "in the absence of a statutory change". We feel the Commission is gravely misguided in seeking to impose a deadline on Congress, especially since Congress has already made its intent clear.

Therefore, we strongly urge the Commission to reconsider its intention to determine that gold and silver leverage transactions are futures contracts. In this connection, we trust you will postpone the effective date of the proposed action. We believe that your continued vigilant enforcement of the already-existing leverage antifraud regulation will protect the public while allowing time to work out a permanent regulatory solution that will recognize the needs of the Commission and the interests of commodity customers and responsible leverage transaction firms.

With every good wish, we are

Sincerely,

Jesse Helms
JESSE HELMS
Ranking Minority Member

Herman E. Talmadge
HERMAN E. TALMADGE
Chairman

cc: Honorable Read P. Dunn, Jr.
Honorable Robert L. Martin
Honorable David G. Gartner

STATEMENT OF GE[redacted]ISHMAN, ON BEHALF OF DOWDEX CORPORATION

Mr. Chairman and Members of the Committee:

I thank the Committee for the opportunity to present this statement on behalf of our client, Dowdex Corporation, and would be pleased to try and respond to any questions you may have at the hearing.

The specific area to which this statement is addressed is the area covered by Section 4c(d) of the Commodity Exchange Act-- the Dealer Options area. Some have said that with the advent of exchange traded commodity options the dealer options industry will be hard pressed to compete. Our client, Dowdex Corporation, together with others presently engaged in the granting of and dealing with dealer options, respectfully disagrees.

Dealer options are the "over the counter" interests in commodities. Since, by law, futures contracts may only be traded on designated contracts markets (exchanges)[1], dealer options are, of necessity, options on physical commodities, not futures contracts. Since mid-1978,[2] dealer options lawfully have been granted only by a handful of firms throughout the United States as a result of the CFTC's overreaction to its inability to administer commodity options trading generally. This inability and overreaction has prevented the CFTC from understanding that, typically, option grantor firms are not brokers, or futures commission merchants (FCMs)[3], and it is wholly inappropriate to lump FCMs and option grantors for regulatory or liability purposes.

It is important to point out, as I'm sure was done four years ago, that the dealer options industry, not surprisingly, has been relatively free of the customer complaints and abuses which led to the more general options ban in 1978. This is so, I believe, not only because of the initial regulations which were promulgated by the CFTC, but also because of the strong self-regulatory responsibilities taken on by the option dealing and granting firms and the FCMs to and through which dealer options are dealt in by the public. Suffice it to say that in great part, then, the CFTC and the dealer options industry have complemented one another in the public interest. Hopefully, with the adoption of its pending dealer options regulations amendments, the CFTC will afford even greater opportunities for this industry to grow and for the public to participate in such investments on an even wider scale.

There are, however, two areas in which my clients and I believe the CFTC is in need of congressional direction with respect to dealer options. Accordingly, we respectfully suggest that Section 4c(d) of the Commodity Exchange Act should be amended: (i) to prohibit the CFTC from maintaining regulations imposing strict liability upon option grantor firms without due process of law, and (ii) to clarify for the CFTC that which Congress recognized in 1978, that option grantor firms are companies engaged in a trade or business different than futures commission merchants and should not be treated as if they were the latter, from a minimum financial requirements point of view.

I. Financial Requirements for Options Grantors as Opposed to FCMs.

Section 4c(d)[5] was enacted as an exception to the general "options ban" of Section 4c(c)[6] passed as part of the Futures Trading Act of 1978.[7] The Conference Report accompanying that statute[8] exhorts the CFTC expeditiously to proceed with plans to implement exchange trading of commodity options consistent with the provisions of the amendments[9]. In theory, as noted above, exchange traded options would provide significant competition to dealer options in the minds of speculators and hedgers wishing to trade in commodity options generally. However, it is now clear, four years later, that this significant competition has not "expeditiously" occurred as Congress originally envisioned. While exchange traded options are now "on the table", so to speak, it is not necessary to believe that trading in options on commodity exchanges competitively will negate interest in dealer options on the part of the investing or hedging public. Indeed, we suggest that for Congress to continue to foster competition in the dealer options area, a segment of the commodity options genre where few, if any, significant customer complaints or grantor firm problems have existed under the current system of regulations, is laudatory and in the public interest, generally.

Not anyone should be entitled to grant dealer options to the public without possessing some financial strength and stability. This was recognized by Congress, as it enacted Section 4c(d)(2)(A)(ii) requiring a grantor at all times to have "a net worth of at least $5,000,000 certified annually by an independent public accountant using generally accepted accounting principles".[10] Such a provision clearly is restrictive of the number of firms which could hope to qualify as grantors of dealer options. To be sure, this is less restrictive than the original CFTC Regulation 32.12 or the original 1978 Senate proposed version of the provision[11]. Nevertheless, the objective evidence is that this "net worth" level has ensured, and should continue to ensure, the financial stability of the industry, given current general economic considerations.

At the same time there is no reason why firms having a minimum threshhold net worth of $5,000,000 computed in accordance with generally accepted accounting principles and subject to the detailed safeguards of the requirements of the balance of Section 4c(d)(2)(A)[12], including daily segregation of options takers' "in-the-money" amounts, could not lawfully engage in the business of granting dealer options efficiently, economically and in the public interest. Furthermore, as Congress plainly saw in 1978, and as the CFTC still fails to see[13], option grantors are commercial enterprises which are not FCMs, and the imposition of additional net capital requirements on option grantors, as if they were FCMs, over and above a significant threshhold net worth requirement continues the potentiality for an overly restrictive government sponsored oligopoly to the detriment of the trading and investing public. With the benefit of hindsight, more than four years after the last of the CFTC's major embarrassments in attempting to regulate commodity options generally, there is no reason to add to a well working regulation an additional, prohibitively high net capital requirement into the dealer options granting business, such requirement having little, if any, proper applicability outside brokerage firms in this context.

II. Liability Without Due Process of Law.

Additionally, as part of its overreaction and its frustration, the CFTC has adopted and maintained a rule automatically imposing joint and several liability upon option grantors for the adjudged liability of an FCM brokering the former's dealer options to the public.[14] The perceived necessity for abrogating due process, to which option grantors, as well any other entity or individual, are entitled, has never materialized. Fundamental fairness, as well as the due process clause,[15] requires that an option grantor not be strictly liable for the acts or omissions of an independently operated and separately financed and regulated FCM which, as broker for its clients, trades in the dealer options of a particular grantor. In the absence of breach of contract or fraud on the part of the option grantor, such liability should not be the obligation of the option grantor, especially without the ability to defend itself in our adversary system for adjudicating disputes.

III. Conclusion.

To summarize, dealer option grantors should be subject to no net capital requirement in addition to an already existing substantial and appropriate net worth requirement, nor should dealer option grantors be subject to joint and several liability for violations not their own.

AMENDED TEXT

In order to implement the foregoing, Dowdex Corporation respectfully suggests that Section 4c(d)[16] be amended to read as follows:

> "(d) Notwithstanding the provisions of [any sections delimiting or delineating other commodity options, prohibitions, restrictions, etc.] --
>
> "(1) the Commission shall issue regulations, including registration with the Commission, that permit grantors and futures commission merchants to offer to enter into, enter into, or confirm the execution of, any commodity option transaction on a physical commodity subject to the provisions of subsection (b) of this section if --
>
> "(A) the grantor is a person who --
>
> "(i) at all times has total assets in excess of total liabilities, or net worth, of at least $5,000,000 certified annually by an independent public accountant using generally accepted accounting principles;
>
> "(ii) notifies the Commission and every futures commission merchant offering the grantor's option if the grantor knows or has reason to believe that the grantor's total assets minus total liabilities, or net worth, has fallen below $5,000,000;
>
> "(iii) segregates daily, exclusively for the benefit of purchasers, money, exempted securities [within the meaning of

Section 3(a)(12) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(12)], commercial paper, bankers' acceptances, commerical bills, or unencumbered warehouse receipts equal to an amount by which the value of each transaction exceeds the amount received or to be received by the grantor for such transactions;

"(iv) provides an identification number for each transaction; and

"(v) provides confirmation of all orders for such transactions executed, including the execution price and a transaction identification number;

"(B) ...

"(iv) provides a disclosure statement to its customers, under regulations of the Commission, that discloses, among other things, to the extent practicable and known, all costs, or methods and factors of determining such costs, including the mark-ups or commissions involved in such transactions.

"(C) REPEALED

"The Commission may terminate the right of any person to grant, offer, or sell options under this subsection only after a hearing, including a finding that the continuation of such right is contrary to the public interest."

Section 4c(e) should be repealed.

Again, I thank you for the opportunity to testify, and would be pleased to respond to any questions to the best of my ability.

Respectfully submitted,

Gerald L. Fishman

Gerald L. Fishman
for FISHMAN MERRICK PERLMAN & NAGELBERG, P.C.

GLF:wfm
cc: Dowdex Corporation

FOOTNOTES

1. 7 U.S.C.§6 (1976).

2. The CFTC's dealeroptions exception to its general bank on commodity options trading in the United States commenced with the initial adoption of 17 C.F.R.§32.12 (1980). This was codified in substantial part with the enactment on Oct. 1, 1978 of the Futures Trading Act of 1978 7 U.S.C. §6c(d) (Supp. 1978).

3. See CFTC, Prhohibited Trading in "Puts" and "Calls" in Non-regulated Commodities, 17 C.F.R. §1.19 (1980).

4. CFTC, Exemption from Suspension of Commodity Option Transactions, 17 C.F.R. §32.12(b)(4)(1980).

5. Commodity Exchange Act, 7 U.S.C. §6c(d) (Supp. 1978).

6. 7 U.S.C. §6c(c).

7. Futures Trading Act of 1978, Pub. L. No. 94-505, 92 Stat. 865 (1978).

8. Conference Committee Rep. No. 95-1239, 95th Cong. 2d Sess. (1978).

9. _Id_. at 20.

10. 7 U.S.C. §6c(d)(2)(A)(ii).

11. S. 2391, 95th Cong., 2d Sess. (1978).

12. 7 U.S.C. §6(d)(2)(A).

13. Proposed Reissuance of and Amendments to Regulations Permitting the Grant, Offer and Sale of Options on Physical Commodities, 46 Fed. Reg. 23,469, 23,473 (4/27/81).

14. *See* note 4 *supra*.

15. U.S. Const. amend. v.

16. *See* note 5 *supra*.

STATEMENT OF GEORGE ROSENTHAL, CHAIRMAN
NATIONAL AFFAIRS COMMITTEE
# of the
INDEPENDENT BAKERS ASSOCIATION

Mr. Chairman, my name is George Rosenthal and I am President of Fink Baking Corporation, a variety baker located in Long Island City, New York. We are members of the Independent Bakers Association, (IBA), a Washington-based trade association of small and medium-sized wholesale bakers. I serve as chairman of the National Affairs Committee of IBA and appear today in that capacity. IBA members manufacture over 55% of the wholesale bread sold in the United States.

The basic raw materials of the baking industry are agricultural commodities which are purchased through and whose prices are established day to day by the trading of futures contracts over the several exchanges which are regulated by the Commodity Futures Trading Commission (CFTC). I want to thank you for the opportunity to come before this Subcommittee and discuss the extraordinary influence these markets have on the products used by the baking industry.

In recent years the baking industry has expressed concern regarding the high ratio of speculative contracting to user hedging in certain agricultural commodities. On September 22, 1980 before the Subcommittee on Special Small Business Problems of the House Committee on Small Business, an IBA baker reported on the adverse effects of tremendous speculative interest in sugar on the New York Coffee, Sugar, and Cocoa Exchange.

In the fall of 1980, the price for a sugar contract on the New York Exchange reached a five year high of 44 cents a pound. This represented a near 3 fold increase in sugar's cost of production of between 13 and 20 cents.

The New York Exchange is responsible for setting the world market price for sugar, both beet and cane. Yet only a small percentage of the world sugar is purchased directly through this market. On the other hand, individual speculators must concentrate almost all of their investment on the New York Exchange.

Consequently, when reports from the commodity brokerage houses and financial newspapers and magazines began predicting shortages of sugar in the spring and summer of 1980 we saw a mass entrance into the sugar market by speculators and small investors. In 1980 almost twice the number of contracts were sold than in 1979 when prices were stable and interest was low.

Mr. Chairman, a fixed supply of contracts was sold to an inflated number of purchasers, causing a panic-like rush for contracts and hence a rapid increase in the price a baker had to pay for sugar. In November 1980 the price broke and in less than 3 months we returned to near normal prices.

As a baker I can relate a similar story about wheat prices. In 1972 the farmer received about $1.25 per bushel of wheat. In less than a year the price rose to over $6.00 per bushel. Behind these runaway prices was the much publicized Russian wheat purchase of only 13.5 million metric tons of wheat and corn. Though this purchase caused the price of wheat to more than triple and add over 5 cents to the average price of a loaf of bread, it was a mere 10% of out total wheat crop, of which 70% is exported annually, and hardly a purchase which should have created such a dramatic increase in price. During this same period similar price run-ups occurred in soybeans and shortening which added additional pressure on the wholesale baker.

As a result of price rise the small and medium sized wholesale baker was severely impacted. In 1974 the continued high price of commodities brought the close of over 68 wholesale bakery plants and caused the worst economic era the baker has faced since the 1930's.

And when these price run-ups occur, the price to the baker and consumer never return to their former levels. This puts great inflationary pressure on the economy.

A study prepared by the staff of the House Committee on Small Business analyzed live cattle futures trading and observed a systematic trading phenomenon, perhaps unique to live cattle futures, which predicted certain live cattle future price drops with perfect accuracy. This knowledge may have been used to profit "insider" futures transactions to the disadvantage of traders not privy to it. At that time, shortside speculation accounted for 70% interest and longside speculation for 93%. It was noted that officers of commercial feedlots were speculating in patterns similar to their companies. These examples of the effects of a high ratio of speculation in certain markets do not apply to all commodities trading at all times, but they happen enough to concern our membership.

Mr. Chairman, we are speaking of products essential to the consumer and the nation. Bread is often called the staff of life and depends on orderly markets of the agricultural products that a baker requires to produce our nation's baked foods. And history shows us what can happen to a society when the price of bread doubles.

In recent years this nation has twice observed the public "jumping" into the commodities markets to take advantage of shortages in sugar and silver supplies. The results were price rises to levels far above what should have been dictated by supply and demand. It seems to IBA that low margins on speculative futures contracts contribute to these speculative excesses. We contend that it is not in the public interest to have commodity price swings aggravated by contracts which are controlled by deposits for but a small fraction of the contract worth.

Therefore, IBA urges this Subcommittee take two actions in drafting new authorizing legislation for the CFTC:

First, we propose giving the Commission authority to set margin rates for non-business related speculation. This will give the Commission power to act when and if it determines prices have reached unrealistic levels and non-business related speculations are distorting an unrealistic price picture.

This action will allow the CFTC to act in time to save the the small businessman, whether jeweler or baker, who can be destroyed in speculative excesses.

The Commission should also be empowered to curb individuals and groups within the industry whose buying and selling of futures contracts exceed their business related needs, although exempting professional brokers and traders whose actions might be required to keep orderly markets.

The margin level for non-business related futures speculative trading should be set at 50% of the value of the contract and the enabling legislation should spell out this minimum requirement. The system under which the Federal Reserve Board sets margin levels for the nation's securities exchanges has proven successful in reducing excessive speculation so rampant before the SEC Act was approved in the 1930's. The current margin for all securities transactions is 50% cash or 500% higher than the 10% margins that existed during the speculative disasters of 1929 and the early 1930's.

Mr. Chairman, it is interesting to note that the securities markets achieved enormous increases in trading volumes with higher margin rates, which was contrary to industry predictions when they went into effect and which is contrary to current industry predictions if higher margins for commodity futures trading are enacted. In fact, increased volume in the securities markets has meant active, viable markets for securities buyers and sellers.

IBA submits that such higher margins on non-industry related future transactions will significantly reduce the wide swings of commodity prices.

Second, we propose directing the CFTC to set up a system of computer monitoring of the various commodities trades on the exchanges. This information bank will enable CFTC specialists to discover unusual or irregular patterns that distort the trading markets.

Such a system in place would discourage the possibility of synchronous trading as a result of prohibited direct contact between traders. And no one, including the CFTC surveillance unit whose responsibility it is to oversee this market, knows at present what all the trading groups are doing on an exchange on a given day in relation to what they are doing on another on this or that day or for which delivery date or with what degree of synchronization or independence they are occurring.

Mr. Chairman, the law is broad on the side of prohibiting collective trading for the purpose of exceeding trading limits, requiring neither simultaneous trading nor identical quantities as grounds for a violation. While we appreciate the protections this provides, it has no bearing on the Commission's ability to discover such violations.

In our view, CFTC surveillance specialists backed up by the computer capability to analyze and correlate the millions of trading data collected annually on the activity of traders will discover not the single limited effect on markets of one exchange, but the aggregate impact of those trades. They will be in a position to flag traders misusing their positions.

To summarize, fluctuations in the prices of agricultural commodities used by the baking industry, as well as the agricultural and non-agricultural commodities basic to other industries which result from those factors not in the interest of establishing fair and reasonable pricing mechanisms, are injurious to the American consumer and the national economy.

The IBA calls on you, Mr. Chairman, to investigate the necessity for CFTC to have the capability of setting margins for non-industry related speculation. Also we urge that the CFTC acquire the capacity of analyzing on a daily basis future transactions across all exchanges. This recommendation is made not for the purpose of restricting or influencing speculation but to ensure the markets provide a hedging vehicle to all traders and thereby an efficient price discovery mechanism to the benefit of the user and the general public.

Thank you, Mr. Chairman.

STATEMENT OF GLENN WILLETT CLARK, GLENN WILLETT CLARK ASSOCIATES, MCLEAN, VA.

Concern has developed that futures markets, and CFTC regulation thereof, have cast off from their agricultural moorings, and somehow left service of agriculture in the lurch. I should like to place these misgivings in historic and analytical perspective.

I. Futures markets are now more than agricultural, and the historic 1974 creation of the CFTC, wrought by the Senate, is largely responsible for the creation of a financial tool of incredible versatility.

1. Futures markets must not be confused with cash forward markets—but this proposed legislation blurs the distinction.

2. Forward markets work within different traditions in each of several cash markets: metals (precious), financial instruments, corporate equities, domestic staple agriculture, domestic specialty agriculture, tropical agriculture, petroleum, coal, natural gas, non-ferrous industrial metals, lumber—but the CFTC largely fails to recognize this.

3. Futures markets exist, mainly, to offset forward contract commitments—not to offset inventory positions (except in domestic staple agriculture, and then not exclusively).

4. Hedgers do not strive to break even, but, rather, to make money on basis shift, on the arbitraged interplay between cash (forward) markets and futures (exchange) markets.

II. Both the SEC and CFTC would gain expanded jurisdiction under the Shad-Johnson "accord" to be ratified by this legislation.

1. SEC acquires jurisdiction over all options on certain nonsecurities, e.g. bank certificates of deposit.

2. The SEC would acquire, unintended, a vast new jurisdiction over mortgage markets, housing finance, bank operations, and over authentic generic futures on interest rate hedging instruments.

3. The CFTC, in consequence of blurring the distinction between forward contracting and futures exchange operations, would, inevitably, abandon its focus on exchange and clearing house operations, and the utility of proposed new hedging arrangements, to focus, instead, on garden variety fraud, and on the boiler-room retailing of investment contract securities.

4. The states and the SEC, jurisdictional boundaries being properly understood, have always had this needed jurisdiction—or would have had, but the CFTC's misguided historic insistence that it knew better than Congress, that it could, exclusively, create and superintend a cash forward market in options.

5. The only needed change in exclusive jurisdiction is a CFTC retreat from ground it was not assigned to defend—ground within the terrain of cash forward markets, e.g., dealer options, vending of investment contract securities styled cash forward commodity contracts (but mislabeled "off-exchange futures" by the CFTC), and certain illicit variations on the "leverage contracting" theme—which is properly, exclusively, within the domain of the CFTC when "leverage" contract vendors cover their positions in futures. This is, crudely put, a "jobbing" of futures. Then the CFTC does have, should have, and should exercise, by finally writing regulations, an exclusive jurisdiction.

STATEMENT OF CARL W. EK, LEGISLATIVE ASSISTANT, NATIONAL FARMERS UNION

Mr. Chairman and Members of the Subcommittee:

I am Carl Ek, Legislative Assistant for the National Farmers Union. We would like to thank you for this opportunity to present before your subcommittee our testimony on the proposed reauthorization of the Commodity Futures Trading Commission (CFTC).

The principal concern of the National Farmers Union (NFU) in this, as in most other issues, is that the interests of the family agricultural operation be both protected and promoted.

The National Farmers Union feels that in the 1980's, producers may increasingly turn to futures contracts as a marketing tool. As farmers attempt to ride out the current tide of recession and high interest rates, the price insurance offered by hedging is becoming an attractive alternative to the cash market. Our interest in these reauthorization proceedings is, therefore, a keen one.

The first and most important question of these hearings is whether or not the reauthorization should take place at all. With the creation last year of the National Futures Association, the futures industry now has in place an organization which, some claim, would allow the industry to become self-regulating and the CFTC to simply melt away. This argument cannot be accepted uncritically. It is, after all in the strongest interests of the NFA's members that the integrity of the market be preserved. We trust that they will work to guard against the loss of confidence in the market which would be caused by serious irregularities.

Eventually, the NFA may be able to assume some of the regulatory functions now exercised by the CFTC, such as auditing and registration. For the time being, however, the National Farmers Union views the Commission as the best form of insurance the public has to assure that the market will continue to operate in as nearly a state of perfect competition as possible. Its operations preclude the conflict-of-interest potential suggested by complete self-regulation.

The CFTC was authorized by Congress eight years ago in response to an astonishing surge in domestic and international trading activity. Today, the Commission's principle operations include licensing, a reparation's program, and a surveillance of the markets to prevent fraud and manipulation.

Additionally, the Commission's Economic and Education Division prepares a variety of newsletters and reports for public distribution, and conducts numerous meeting with producer groups nationwide. And since timely and accurate information is essential to commodities trading, the NFU would strongly oppose the curtailment of or reduction in these valuable services.

We support the Commission's two-part proposal that it be permitted to share evidence and information with state law enforcement agencies, and that those agencies be authorized to prosecute certain commodity fraud cases under their own laws. In conjunction with this, we recommend that the Commission's Office of the General Counsel review existing state laws to determine whether they are at least as adequate and stringent as the federal statute. We believe such federal-state cooperation would serve the dual purpose of accelerating the judicial process as well as easing the strain on the Commission's resources.

Perhaps the most controversial issue in the reauthorization process is the CFTC's recent proposal that it become a self-funding operation through the imposition of user fees. The National Farmers Union is strongly opposed to this for two major reasons.

In the first instance, we seriously doubt whether the full cost of user fees can readily be absorbed either by the floor brokers or the futures commission merchants for whom they trade. We belive that user fees, like any other externally imposed expense in the marketing system, will ultimately settle upon the producer.

A second major objection we have to the levying of user fees is the tacit assumption of the Administration that, like the owners of yachts and private planes, participants in the futures markets should shoulder the entire financial burden of the federal supervision provided them. This argument might have a sound basis if those who actively trade were the sole beneficiaries of the Commission's services. However, we believe that by facilitating orderly trade, the Commission is providing a public good, the benefits of which accrue to the whole of society.

For these reasons we regard user fees as both disruptive and inequitable for those in the agricultural sector, and income regressive for consumers. We strongly recommend that the Subcommittee authorize appropriations for the Commission at a level equal to or exceeding that for the current fiscal year. The expansion and diversification of the futures industry, and the accompanying strain on the Commission's resources demand nothing less.

Another area being debated in these hearings is that of the Commission's so-called "emergency powers". The National Farmers Union believes that the Commission should retain the ability to quickly intervene in the market in response to severe disruptions. In the past, such emergency powers have been exercised only as a last resort to worsening non-competive market movements. The exchanges possess certain emergency powers; the CFTC has never prevented exchanges usuage of such powers.

We also hold that the Commission's emergency powers would be seriously enervated by the introduction of judicial review. The authorization of such review would tend to increase litigation on the one hand while diluting the deterrent effect on the other. We would liken this to passing a 55 mile per hour speed limit with no violation penalty.

Last fall the Commission granted its approval of a pilot program in options trading. Options contracts provide the opportunity, but not the obligation, to buy or sell a commodity at an agreed upon price. Unfortunately, this form of contract still bears the onus of past scandals resulting from unscrupulous trading practices. It is important to note, however, that these fraudulent activities occurred in an unregulated environment.

The Commission now feels it can develop the capability to effectively monitor trading in options contracts to the same degree that it handles futures. Additional rules, they claim, can be "folded into" existing regulatory structures.

Because the holder of an option has the right to abandon his contract on the expiration date, he stands to loose at most the premium he has paid. This limited liability aspect has promoted several agricultural economists to suggest that option contracts on agricultural commodities might prove to be a useful risk management device for producers.

We trust that the subcommittee will allow the current pilot program to run its course before opening up the field any further. During this trial period, the Commission will have ample opportunity to gather information on financial instruments options, and then assess the probable effect such trade would have in agricultural commodities. We urge the subcommittee to request of the Commission a final report which would evaluate the performance of options trading during the trial period, and recommend on the feasibility of trading in agricultural commodities options.

On the remainder of the proposals contained in the Futures Trading Act of 1982, we defer to this subcommittee's good judgement as to the effect upon the family farm. We support the overall thrust of this legislation, which would attempt to streamline and delegate enforcement authority, and call for greater accountability of market participants. Both of these general policies should assist in reducing unnecessary time and expense in the courts.

Mr. Chairman, this concludes my testimony. I will be happy to remain and answer any questions you or members of the Subcommittee might have.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

March 12, 1982

Dear Mr. Chairman:

The purpose of this letter is to express the Administration's position on the reauthorization of the Commodity Futures Trading Commission (CFTC).

After careful consideration at the sub-Cabinet and Cabinet levels, the Administration recommends:

1. Reauthorizing the CFTC for a fixed period of at least four years;
2. Offsetting the costs of the CFTC through user fees without discouraging membership in the National Futures Association;
3. Retaining the CFTC's exclusive regulatory jurisdiction over national exchange trading and pool operators;
4. Authorizing the CFTC to share information with State governmental authorities in connection with legal actions or investigations conducted by States; and
5. Incorporating the resolution of the SEC/CFTC jurisdictional dispute approved by Chairmen Shad and Johnson in the CFTC reauthorization bill.

These recommendations are consistent with the provisions of S. 2109 and H.R. 5447 as introduced at the request of the Chairman of the Commodity Futures Trading Commission.

I respectfully request that a copy of this letter be included in the appropriate records of the CFTC reauthorization hearings recently conducted by the Agriculture Committee's Subcommittee on Agricultural Research and General Legislation. This letter is also being transmitted to the Chairman and ranking minority member of the Subcommittee. Thank you for your cooperation on this matter.

Sincerely,

Roger W. Mehle

Roger W. Mehle

The Honorable
Jesse A. Helms, Chairman
Committee on Agriculture, Nutrition
and Forestry
United States Senate
Washington, DC 20510

II

7TH CONGRESS
2D SESSION

S. 2109

To extend the Commodity Exchange Act, and for other purposes.

IN THE SENATE OF THE UNITED STATES

FEBRUARY 11 (legislative day, JANUARY 25), 1982

Mr. HELMS (for himself and Mr. LUGAR) (by request) introduced the following bill; which was read twice and referred to the Committee on Agriculture, Nutrition, and Forestry

---

A BILL

To extend the Commodity Exchange Act, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That this Act may be cited as the "Futures Trading Act of 1982".

DEFINITIONS, JURISDICTIONAL ACCORD WITH THE SECURITIES AND EXCHANGE COMMISSION, AND CERTAIN TECHNICAL AMENDMENTS

SEC. 2. (a) Section 2(a) of the Commodity Exchange Act (7 U.S.C. 2) is amended—

(1) by redesignating subsection 2(a)(1) as subsection 2(a)(1)(A);

(2) by inserting in the third sentence of subsection 2(a)(1)(A), as so redesignated, the words ", except to the extent otherwise provided in subparagraph (a)(1)(B) of this section," after the words "exclusive jurisdiction";

(3) by amending the definition of the term "commodity trading advisor" in subsection 2(a)(1)(A), as so redesignated, to read as follows: "The term 'commodity trading advisor' shall mean any person who, for compensation or profit, engages in the business of advising others, either directly or through publications, writings, or electronic media, as to the value of or the advisability of trading in any contract for future delivery of a commodity made or to be made on or subject to the rules of a contract market, any commodity option authorized under section 4c, or any leverage transaction authorized under section 19, of this Act, or who, for compensation or profit, and as part of a regular business, issues or promulgates analyses or reports concerning any of the foregoing; but does not include (i) any bank or trust company, (ii) any news reporter, news columnist, or news editor of the print or electronic media, or any lawyer, accountant or teacher, (iii)

any floor broker or futures commission merchant, (iv) the publisher or producer of any print or electronic data of general and regular dissemination, including its employees, (v) the fiduciary of any defined benefit plan which is subject to the provisions of the Employee Retirement Income Security Act of 1974, (vi) any contract market, and (vii) such other persons not within the intent of this definition as the Commission may specify by rule, regulation or order: *Provided,* That the furnishing of such services by the foregoing persons is solely incidental to the conduct of their business or profession: *Provided further,* That the Commission, by rule or regulation, may include within this definition, any person advising as to the value of commodities or issuing reports or analyses concerning commodities, if the Commission determines that such rule or regulation will effectuate the purposes of this provision."; and

(4) by adding a new subsection 2(a)(1)(B) to read as follows:

"(B) Notwithstanding any other provision of law—

"(i) This Act shall not apply to and the Commission shall have no jurisdiction to designate a board of trade as a contract market for any transaction whereby any party to such transaction acquires any put, call or other option on one or more securities (as defined in section 2(1) of the Securities Act of 1933 or section 3(a)(10) of the Securities Exchange Act of 1934 on the effective date of Public Law), including any group or index of such securities, or any interest therein or based on the value thereof.

"(ii) This Act shall apply to and the Commission shall have exclusive jurisdiction with respect to accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an option, privilege, indemnity, bid, offer, put, call, advance guaranty, or decline guaranty) and transactions involving, and may designate a board of trade as a contract market in, contracts of sale (or options on such contracts) for future delivery of a group or index of securities (or any interest therein or based upon the value thereof): *Provided, however,* That no board of trade shall be designated as a contract market with respect to any such contracts of sale (or options on such contracts) for future delivery unless the board of trade making such application demonstrates and the Commission expressly finds that the specific contract (or option on such contract) with respect to which the application has been made meets the following minimum requirements:

"(a) Settlement of or delivery on such contract (or option on such contract) shall be effected in cash or by means other than the transfer or receipt of any security, except an exempted security under section 3 of the Securities Act of 1933 or section 3(a)(12) of the Securities Exchange Act of 1934 as in effect on the effective date of Public Law (other than any municipal security, as defined in section 3(a)(29) of the Securities Exchange Act of 1934 on the effective date of Public Law);

"(b) Trading in such contract (or option on such contract) shall not be readily susceptible to manipulation of the price of such contract (or option on such contract), nor to causing or being used in the manipulation of the price of any underlying security, option on such security or option on a group or index including such securities;

"(c) Such group or index of securities shall be predominately composed of the securities of unaffiliated issuers and shall be a widely published measure of, and shall reflect, the market for all publicly traded equity or debt securities or a substantial segment thereof, or shall be comparable to such measure.

"(iii) Upon application by a board of trade for designation as a contract market with respect to any contract of sale (or option on such contract) for future delivery involving a group or index of securities, the Commission shall provide an opportunity for public comment on whether such contracts (or options on such contracts) meet the minimum requirements set forth in subparagraph (ii) hereof, and shall consult with the Securities and Exchange Commission with respect to such designation. If, within fifteen days following the close of the public comment period, the Securities and Exchange Commission shall object to the designation of a board of trade as a contract market in such contract (or option on such contract) on the ground that any minimum requirement of subparagraph (ii) hereof is not met, the Commission shall afford the Securities and Exchange Commission an opportunity for an oral hearing, to be transcribed, before the Commission, and shall give appropriate weight to the views of the Securities and Exchange Commission. Such oral hearing shall be held after the public comment period, prior to Commission action upon such designation, and not less than thirty nor more than forty-five days after the close of the public comment period, unless both the Commission and the Securities and Exchange Commission otherwise agree. In the event that such an oral hearing is held and the Securities and Exchange Commission fails to withdraw its objections, and the Commission issues an order designating a board of trade as a contract market with respect to any such contract (or option on such contract), the Securities and Exchange Commission shall have the right of judicial review of such order in accordance with the standards of section 6(b) of this Act. In the event that, pursuant to section 6 of this Act, there is a hearing on the record with respect to such application for designation, the Securities and Exchange Commission shall have the right to participate in that hearing as an interested party.

"(iv) No person shall offer to enter into, enter into, or confirm the execution of any contract of sale (or option on such contract) for future delivery of any security, or interest therein or based on the value thereof, except an exempted security under section 3 of the Securities Act of 1933 or section 3(a)(12) of the Securities Exchange Act of 1934 as in effect on the effective date of Public Law (other than any municipal security as defined in section 3(a)(29) of the Securities Exchange Act of 1934 on the effective date of Public Law); or except as provided in subparagraph (ii) hereof, any group or index of such securities or any interest therein or based on the value thereof.".

(b)(1) By redesignating subsection 2(a)(7)(A) (7 U.S.C. 4a(f)(1)) as subsection 2(a)(7); and

(2) By striking out existing subsection 2(a)(7)(B) (7 U.S.C. 4a(f)(2)).

UNLAWFUL FUTURES TRADING, FOREIGN FUTURES

SEC. 3. Section 4 of the Commodity Exchange Act (7 U.S.C. 6) is amended—

(a)(1) by redesignating section 4 as section 4(a);

(2) by striking out all those words following the word "to" the first time it appears, through and including the words "as hereinafter provided,";

(3) by inserting after the word "to" the first time it appears the following: "offer to enter into, to enter into, to execute, to confirm the execution of, or to conduct any office or business anywhere in the United States or its territories or possessions for the purpose of soliciting or accepting any order for, or otherwise dealing in, any transaction in, or in connection with, a contract for the purchase or sale of a commodity for future delivery (other than a contract which is made on a board of trade, exchange or market located outside

the United States, its territories or possessions) unless: (1) such transaction is conducted on or subject to the rules of a board of trade which has been designated by the Commission as a "contract market" for such commodity, (2) such contract is executed or consummated by or through a member of such contract market,"; and

(4) by striking out the word "if" and inserting in lieu thereof "(3)", and by striking out the word "board" after the words "*Provided,* That" and inserting in lieu thereof the words "contract market".

(b) by adding a new subsection (b) to read as follows:

"(b) In addition to its existing authority, the Commission may adopt rules and regulations governing the offer and sale by any person located in the United States, its territories or possessions, of any contract of sale of a commodity for future delivery which is made or to be made on a board of trade, exchange or market located outside the United States, its territories or possessions.".

SPECULATIVE LIMITS

SEC. 4. Section 4a of the Commodity Exchange Act (7 U.S.C. 6a) is amended—

(a) by striking out the word "order's" in subparagraph (2);

(b) by inserting the words "rule, regulation, or order" before the semicolon in subparagraph (2);

(c) by adding the words "rule, regulation, or" before the word "order" wherever it occurs;

(d) by striking out the words "within one hundred and eighty days after the effective date of the Commodity Futures Trading Commission Act of 1974" in subparagraph (3); and

(e) by adding a new subparagraph (5) to read as follows:

"(5) Nothing in this section shall prohibit or impair the adoption by any contract market or by any other board of trade licensed or designated by the Commission, of any bylaw, rule, regulation, or resolution fixing limits on the amount of trading which may be done or positions which may be held by any person under contracts of sale of any commodity for future delivery traded on or subject to the rules of such contract market, or under options on such contracts or commodities, traded on or subject to the rules of such contract market or such board of trade: *Provided*, That if the Commission shall have fixed limits under this section for any contract or under section 4c of this Act for any commodity option, the bylaws, rules, regulations, and resolutions adopted by such contract market or such board of trade shall not differ from the limits fixed by the Commission except with the approval of the Commission. It shall be unlawful for any person to violate any bylaw, rule, regulation, or resolution of any contract market or other board of trade licensed or designated by the Commission fixing limits on the amount of trading which may be done or positions which may be held by any person under contracts of sale of any commodity for future delivery or under options on such contracts or commodities, if such bylaw, rule, regulation or resolution has been approved by the Commission.".

OPTIONS ON FOREIGN CURRENCY, ROLE OF SECURITIES AND EXCHANGE COMMISSION

SEC. 5. Section 4c of the Commodity Exchange Act (7 U.S.C. 6c) is amended by adding a new subsection (f) to read as follows:

"(f) Nothing in this Act shall be deemed to govern or in any way be applicable to any transaction in an option on foreign currency traded on a national securities exchange.".

TECHNICAL AMENDMENTS

SEC. 6. Section 4f of the Commodity Exchange Act (7 U.S.C. 6f) is amended—

(a) by striking out the words "and of all correspondents and agents" and by striking out the words "after notice and hearing as prescribed in this Act" in subparagraph (1); and

(b) by adding at the end of subparagraph (1) the words "pursuant to the provisions of this Act".

SEC. 7. Section 4h of the Commodity Exchange Act (7 U.S.C. 6h) is amended—

(a) by striking out everything following the word "person" and including "(2)";

(b) by striking out the words "futures commission merchant registered" and by inserting in lieu thereof the word "registrant";

(c) by striking out the words "such registered futures commission merchant" and inserting in lieu thereof the words "any registrant"; and

(d) by adding the words "representative or" before the word "agent" the second time it appears in existing subparagraph (2).

RECORDKEEPING CONFORMED TO CURRENT SYSTEM

SEC. 8. Section 4i of the Commodity Exchange Act (7 U.S.C. 6i) is amended to read as follows: "It shall be unlawful for any person to make any contract for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market (1) if such person shall directly or indirectly make such contracts with respect to any commodity, or any future of such commodity, during any one day in an amount equal to or in excess of such amount as shall be fixed from time to time by the Commission, and (2) if such person shall directly or indirectly have or obtain a long or short position in any commodity or any future of such commodity, equal to or in excess of such amount as shall be fixed from time to time by the Commission, unless, such person files or causes to be filed with the properly designated officer of the Commission such reports regarding any transactions or positions within the provisions of (1) and (2) hereof as the Commission may by rule or regulation require and unless, in accordance with rules and regulations of the Commission, such person shall keep books and records of all such transactions and positions and transactions and positions in any such commodity traded on or subject to the rules of any other board of trade, and of cash or spot transactions in, and inventories and purchase and sale commitments of, such commodity. Such books and records shall show complete details concerning all such transactions, positions, inventories, and commitments, including the names and addresses of all persons having any interest therein, and shall be open at all times to inspection by any representative of the Commission or the United States Department of Justice. For the purposes of this section, the futures and cash or spot transactions and positions of any person shall include such transactions and positions of any persons directly or indirectly controlled by such person.".

REGISTRATION, ASSOCIATED PERSON STATUS

SEC. 9. Section 4k of the Commodity Exchange Act (7 U.S.C. 6k) is amended—

(a) by amending subsection 4k(1) as follows:

(1) by striking out the word "any" and inserting in lieu thereof the word "a" before the words "futures commission merchant" each time they appear;

(2) by inserting the word "been" before the word "revoked" each time it appears;

(3) by striking out the word "nor" and inserting in lieu thereof ",";

(4) by striking out the words "or with any agent of a futures commission merchant", "or any agent of a futures commission merchant", and "or agent";

(5) by striking out the word "or" before the word "employee" and adding the words "or agent" after the word "employee"; and

(6) by adding the word "is" before the word "registered" and the words "is an associated person of such futures commission merchant" after the word "registered";

(b) by redesignating existing subsection 4k(2) as subsection 4k(4);

(c) by adding a new subsection 4k(2) to read as follows:

"(2) It shall be unlawful for any person to be associated with any commodity pool operator as a partner, officer, employee or agent (or any person occupying a similar status or performing similar functions), in any capacity which involves (i) the solicitation of funds, securities, or property for a participation in a commodity pool or (ii) the supervision of any person or persons so engaged, unless such person is registered as an associated person of such commodity pool operator, under this Act, with the Commission and such registration shall not have expired, been suspended (and the period of suspension has not expired) or been revoked, and it shall be unlawful for any commodity pool operator to permit such a person to become or remain associated with him in any such capacity if such commodity pool operator knew or should have known that such person was not so registered or that such registration had expired, been suspended (and the period of suspension has not expired) or been revoked: *Provided*, That any individual who is registered as a floor broker, futures commission merchant, commodity pool operator, or as an associated person of another category of registrant under this section (and such registration is not suspended or revoked) need not also register under this provision: *Provided further*, That the Commission may exempt any person or class of persons from having to register under this provision by rule, regulation, or order.";

(d) by deleting existing subsection 4k(3);

(e) by adding a new subsection 4k(3) to read as follows:

"(3) It shall be unlawful for any person to be associated with any commodity trading advisor as a partner, officer, employee or agent (or any person occupying a similar status or performing similar functions), in any capacity which involves (i) the solicitation of a client's or prospective client's discretionary account or (ii) the supervision of any person or persons so engaged, unless such person is registered as an associated person of such commodity trading advisor, under this Act, with the Commission and such registration shall not have expired, been suspended (and the period of suspension has not expired) or been revoked, and it shall be unlawful for any commodity trading advisor to permit such a person to become or remain associated with him in any such capacity if such commodity trading advisor knew or should have known that such person was not so registered or that such registration had expired, been suspended (and the period of suspension has not expired) or been revoked: *Provided*, That any individual who is registered as a floor broker, futures commission merchant, commodity trading advisor or as an associated person of another category of registrant under this section (and such registration is not suspended or revoked) need not also register under this provision: *Provided further,* That the Commisison may exempt any person or class of persons from having to register under this provision by rule, regulation, or order.";

(f) by amending subsection 4k(4) as so redesignated—

(1) by striking out "such" and "other" the first time they appear;

(2) by striking out the words "two years after the effective date thereof or";

(3) by striking out the words ", not less than one year from the date of issuance thereof," and everything after the word "prescribe"; and

(4) by inserting the words "as an associated person of a futures commission merchant, of a commodity pool operator, or of a commodity trading advisor" after the word "registered" the first time it appears; and

(g) by adding a new subsection 4k(5) to read as follows:

"(5) It shall be unlawful for any registrant to permit a person to become or remain an associated person of such registrant, if the registrant knew or should have known, of facts regarding such associated person that are set forth as statutory disqualifications in section 8a(2) of this Act.".

SECURITIES AND EXCHANGE COMMISSION ROLE IN RESPECT TO COMMODITY POOLS

SEC. 10. Section 4m of the Commodity Exchange Act (7 U.S.C. 6m) is amended—

(a) by redesignating existing section 4m as subsection 4m(1); and

(b) by adding a subsection 4m(2) to read as follows:

"(2) Nothing in this Act shall relieve any person of any obligation or duty, or affect the availability of any right or remedy available to the Securities and Exchange Commission or any private party arising under the Securities Act of 1933 or the Securities Exchange Act of 1934 governing the issuance, offer, purchase, or sale of securities of a commodity pool, or of persons engaged in transactions with respect to such securities, or reporting by a commodity pool.".

CONFORMING AMENDMENT

SEC. 11. Section 4n of the Commodity Exchange Act (7 U.S.C. 6n) is amended by striking out subsections 4n(5) and 4n(6) in their entirety.

EXTENSION OF ANTIFRAUD PROVISION

SEC. 12. Section 4o of the Commodity Exchange Act (7 U.S.C. 6o) is amended—

(a) by striking out the word "or" and inserting in lieu thereof the words ", associated person of a commodity trading advisor," after the words "commodity trading advisor" each place such words occur; and

(b) by inserting the words "or associated person of a commodity pool operator," after the words "commodity pool operator" each place such words occur.

EXTENSION OF AUTHORITY REGARDING PROFICIENCY EXAMINATIONS

SEC. 13. Section 4p of the Commodity Exchange Act (7 U.S.C. 6p) is amended—

(a) by striking out the words "futures commission merchants, floor brokers, and those persons associated with futures commission merchants or floor brokers" and by inserting in lieu thereof the words "persons registered with the Commission";

(b) by striking out the words "as the futures commission merchants, floor brokers, and those persons associated with futures commission merchants or floor brokers";

(c) by striking out the word "the" before the word "customers" and by striking out the words "or futures commission merchants and floor brokers" after the word "customers"; and

(d) by inserting the words ", clients, pool participants or other members of the public with whom such individuals deal" after the word "customers".

CONTRACT MARKET RULES

SEC. 14. Section 5a of the Commodity Exchange Act (7 U.S.C. 7a) is amended as follows:

(a) by amending subsection 5a(8) to read as follows:

"(8) enforce all bylaws, rules, regulations, and resolutions, made or issued by it or by the governing board thereof or any committee, which (1) have been approved by the Commission pursuant to paragraph (12) of section 5a of this Act, (2) have become effective under such paragraph, or (3) must be enforced pursuant to any Commission rule, regulation or order; and revoke and not enforce any bylaw, rule, regulation, or resolution, made, issued, or proposed by it or by the governing board thereof or any committee, which has been disapproved by the Commission;";

(b) by amending subsection 5a(11)—

(1) by striking out the comma before subparagraph (ii) and by striking out subparagraphs (ii) and (iii) in their entirety;

(2) by redesignating subparagraph (iv) as subparagraph (ii); and

(3) by striking out the words "a futures commission merchant or a floor broker" and inserting in lieu thereof the words "another member of the contract market" in subparagraph (ii) as so redesignated;

(c) by amending subsection 5a(12) to read as follows:

"(12) except as otherwise provided in this subsection, submit to the Commission for its prior approval all bylaws, rules, regulations, and resolutions (rules) made or issued by such contract market, or by the governing board thereof or any committee thereof, which are of major economic significance, or which relate to terms and conditions in contracts of sale to be executed on or subject to the rules of such contract market, as such terms and conditions are defined by the Commission by rule or regulation, except those rules relating to the setting of levels of margin. Each contract market shall submit to the Commission all other rules (except those relating to the setting of levels of margin) and shall not place such rules into effect if, within ten days of receipt by the Commission of such submission, the contract market requests review and approval thereof by the Commission or the Commission notifies such contract market in writing of its determination to review for approval such rules. At least thirty days before approving any rules of major economic significance, as determined by the Commission, the Commission shall publish in the Federal Register a notice of such rules. The Commission shall give interested persons an opportunity to participate in the approval process through the submission of written data, views, or arguments. The determination by the Commission whether any such rules are of major economic significance shall be final and not subject to judicial review. The Commission shall approve rules, within thirty days of their receipt if Commission approval is required or requested hereunder, within thirty days after the Commission determines to review for approval any other rules, or within sixty days of such determination if the Commission determines them to be of major economic significance, unless the Commission notifies the contract market of its inability to complete such approval or review within such period of time. The Commission shall approve such rules if such rules are determined by the Commission not be in violation of this Act or the regulations of the Commission and the Commission shall disapprove, after appropriate notice and opportunity for hearing, any such rule which the Commission determines at any time to be in violation of the provisions of the Act or the regulations of the Commission. The Commission shall specify the terms and conditions under which a contract market may, in an emergency as defined by the Commission, make effective a rule on a temporary basis without prior Commission approval, or without compliance with the ten-day notice requirement under this subsection, or during any period of review by the Commission. In the event of such an emergency, as defined by the Commission, requiring immediate action, the contract market by a two-thirds vote of its governing board may place into effect immediately a temporary rule dealing with such emergency if it notifies the Commission of such action with a complete explanation of the emergency involved.".

APPEALS

Sec. 15. Section 6(b) of the Commodity Exchange Act (7 U.S.C. 9) is amended by inserting after the words "doing business" the words ", or in the case of an order denying registration, the circuit in which the petitioner's principal place of business listed on petitioner's application for registration is located,".

RESTRAINING ORDERS, INJUNCTIONS, WRITS OR MANDAMUS

Sec. 16. Section 6c of the Commodity Exchange Act (7 U.S.C. 13a–1) is amended by adding after the words "restraining order" in the first proviso, the following words: "(other than a restraining order which prohibits any person from destroying, altering or disposing of, or refusing to permit authorized representatives of the Commission from inspecting when and as requested, any books and records or other documents or which prohibits any person from withdrawing, transferring, removing, dissipating, or disposing of any funds, assets or other property)".

CONFIDENTIALITY PROVISIONS—DISCLOSURE

SEC. 17. Section 8 of the Commodity Exchange Act (7 U.S.C. 12) is amended as follows—

(a) by adding the words "or data and information concerning or obtained in connection with any investigation of any person" at the end of subsection (a);

(b) by amending subsection (b) as follows—

(1) by inserting the words "concerning or obtained in connection with any investigation of any person or" after the word "information";

(2) by striking out the word "or" before the words "in an administrative or judicial proceeding"; and

(3) by inserting the words ", in any receivership proceeding involving a receiver appointed in a judicial proceeding brought under this Act, or in any bankruptcy proceeding in which the Commis-

sion has intervened or in which the Commission has the right to appear and be heard under the Bankruptcy Code" at the end of that subsection.

(c) by amending subsection (e) as follows—

(1) by striking out the words "of the Executive Branch"; and

(2) by adding the following words at the end of that subsection: "Upon the request of any department or agency of any State or any political subdivision thereof, acting within the scope of its jurisdiction or any department or agency of any foreign government or any political subdivision thereof, acting within the scope of its jurisdiction, the Commission may furnish to such department or agency any information in the possession of the Commission obtained in connection with the administration of this Act. Any information furnished to any department or agency of any State or political subdivision thereof shall not be disclosed by such department or agency except in connection with any action or proceeding brought under this Act or the laws of such State or political subdivision to which such State or political subdivision, or any department or agency thereof is a party. The Commission shall not furnish any

information to a department or agency of a foreign government or political subdivision thereof unless the Commission is satisfied that the information will not be disclosed by such department or agency except in connection with any action or proceeding brought under the laws of such foreign government or political subdivision to which such foreign government or political subdivision or any department or agency thereof is a party.".

STATUTORY DISQUALIFICATION FROM REGISTRATION

SEC. 18. Section 8a of the Commodity Exchange Act (7 U.S.C. 12a) is amended as follows:

(a) existing subsection 8a(3) is redesignated as new subsection 8a(4) and existing subsection 8a(4) is added to subsection 8a(1);

(b) subsection 8a(1) is amended—

(1) by striking out the words "and persons associated therewith as described in section 4k of this Act";

(2) by inserting the words "associated persons of futures commission merchants," before the words "commodity trading advisers,";

(3) by inserting the words "associated persons of commodity trading advisers," before the words "commodity pool operators,";

(4) by striking out the word "and" after the words "commodity pool operators," and inserting in lieu thereof the words "associated persons of commodity pool operators, and";

(5) by inserting the word "the" before the words "form and manner"; and

(6) by adding a new proviso at the end of that subsection before the semicolon, as follows: ", and in connection therewith to fix and establish from time to time reasonable fees and charges for registrations and renewals thereof: *Provided,* That notwithstanding any provision of this Act, the Commission may grant a temporary license to any applicant for registration with the Commission pursuant to such rules, regulations, or orders as the Commission may adopt: *Provided further,* That the term of any such temporary license shall not exceed six months from the date of its issuance";

(c) by amending subsection 8a(2) to read as follows:

"(2) upon notice, but without a hearing and pursuant to such rules, regulations, or orders as the Commission may adopt, to refuse to register, to register conditionally, to suspend, or to place restrictions upon the registration of, any person and with such a hearing as may be appropriate, to revoke the registration of any person—

"(A) if a prior registration of such person in any capacity has been suspended (and the period of such suspension has not expired) or has been revoked;

"(B) if registration of such person in any capacity has been refused under the provisions of section 8a(3) of this Act within five years preceding the filing of the application for registration or at any time thereafter;

"(C) if such person is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction (except that registration may not be revoked solely on the basis of such temporary order, judgment, or decree), including an order entered pursuant to an agreement of settlement to which the Commission or any Federal or State agency or other governmental body is a party, from (i) acting as a futures commission merchant, floor broker, commodity trading adviser, commodity pool operator, associated person of any registrant under this Act, securities broker, securities dealer, municipal securities broker, municipal securities dealer, transfer agent, clearing agency, securities information processor, investment adviser, investment company or affiliated person or employee of any of the foregoing or (ii) engaging in or continuing any activity involving any transaction in or advice concerning contracts of sale of a commodity for future delivery, or concerning activity subject to Commission regulation under section 4c or 19 of this Act or concerning securities;

"(D) if such person has been convicted within ten years preceding the filing of any application for registration or at any time thereafter of any felony which (i) involves any transactions or advice concerning any contract of sale of a commodity for future delivery, or any activity subject to Commission regulation under section 4c or 19 of this Act, or concerning a security; or (ii) arises out of the conduct of the business of a futures commission merchant, floor broker, comodity trading adviser, commodity pool operator, associated person of any registrant under this Act, securities broker, securities dealer, municipal securities broker, municipal securities dealer, transfer agent, clearing agency, securities information processor, investment adviser, investment company, or an affiliated person or employee of any of the foregoing; or (iii) involves embezzlement, theft, extortion, fraud, fraudulent conversion, misappropriation of funds, securities or property, forgery, counterfeiting, false pretenses, bribery, or gambling; or (iv) involves the violation of section 152, 1341, 1342, or 1343, or chapter 25, 47, 95, or 96 of title 18, United States Code;

"(E) if such person, within ten years preceding the filing of the application or at any time thereafter, has been found by any court of competent jurisdiction, by the Commission or any Federal or State agency or other governmental body, or by agreement of settlement to which the Commission or any Federal or State agency or other governmental body is a party, (i) to have violated any provision of this Act, the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Advisers Act of 1940, the Investment Company Act of 1940, the Securities Investors Protection Act of 1970, the Foreign Corrupt Practices Act of 1977, or any similar statute of a State or foreign jurisdiction, or any rule, regulation, or order under any such statutes, or the rules of the Municipal Securities Rulemaking Board where such violation involves embezzlement, theft, extortion, fraud, fraudulent conversion, misappropriation of funds, securities or property, forgery, counterfeiting, false pretenses, bribery, or gambling; or (ii) to have willfully aided, abetted, counseled, commanded, induced, or procured such violation by any other person;

"(F) if such person is subject to an outstanding order of the Commission denying trading privileges on any contract market to such person, denying, suspending, or revoking such person's membership in any contract market or registered futures association, or barring or suspending such person from being associated with a registrant under this Act or with a member of a contract market or with a member of a registered futures association;

"(G) if, as to any of the matters set forth in paragraphs (A) through (F) of this subsection, such person willfully made any material false or misleading statement or omitted to state any material fact in his application; or

"(H) if refusal, suspension, or revocation of the registration of any principal of such person would be warranted because of a statutory disqualification listed in this subsection; *Provided*, That for the purposes of sections 8a (2) and (3) of this Act, principal shall mean, if the person is a partnership, any general partner or, if the person is a corporation, any officer, director, or beneficial owner of at least ten per centum of the voting shares of the corporation, and any other person that the Commission by rule, regulation, or order determines has the power, directly or indirectly, through agreement or otherwise, to exercise a controlling influence over the activities of such person which are subject to regulation by the Commission: *Provided*, That such person may appeal from a decision to refuse registration, condition registration, suspend, revoke or to place restrictions upon registration made pursuant to the provisions of this subsection in the manner provided in paragraph (b) of section 6 of this Act; and";

(d) by adding new subsection 8a(3) to read as follows:

"(3) to refuse to register or to register conditionally any person, if it is found, after opportunity for hearing, that—

"(A) such person has been found by the Commission or by any court of competent jurisdiction to have violated or has consented to findings of a violation of, any provision of this Act, or any rule, regulation, or order thereunder (other than a violation set forth in subsection (2) of this section), or to have willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of any such provision;

"(B) such person has been found by any court of competent jurisdiction or by any Federal or State agency or other governmental body, or by agreement of settlement to which any Federal or State agency or other governmental body is a party, (i) to have violated any provision of the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Advisers Act of 1940, the Investment Company Act of 1940, the Securities Investors Protection Act of 1970, the Foreign Corrupt Practices Act of 1977, or any similar statute of a

State or foreign jurisdiction, or any rule, regulation, or order under any such statutes, or the rules of the Municipal Securities Rulemaking Board; or (ii) to have willfully aided, abetted, counseled, commanded, induced, or procured such violation by any other person;

"(C) such person failed reasonably to supervise another person, who is subject to such person's supervision, with a view to preventing violations of this Act, or of any of the statutes set forth in paragraph (B) of this subsection, or of any of the rules, regulations, or orders thereunder, and the person subject to supervision committed such a violation: *Provided*, That no person shall be deemed to have failed reasonably to supervise another person, within the meaning of this paragraph if (i) there have been established procedures, and a system for applying such procedures which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and (ii) such person has reasonably discharged the duties and obligations incumbent upon that person, as supervisor, by reason of such procedures and system, without reasonable cause to believe that such procedures and system were not being complied with;

"(D) such person was convicted of a felony other than a felony of the type specified in section 8a(2)(D) of this Act within ten years preceding the filing of the application or at any time thereafter, or was convicted of a felony, including a felony of the type specified in section 8a(2)(D) of this Act, more than ten years preceding the filing of the application;

"(E) such person was convicted within ten years preceding the filing of any application for registration or at any time thereafter of any misdemeanor which (i) involves any transactions or advice concerning any contract of sale of a commodity for future delivery or any activity subject to Commission regulation under section 4c or 19 of this Act or concerning a security; or (ii) arises out of the conduct of the business of a futures commission merchant, floor broker, commodity trading adviser, commodity pool operator, associated person of any registrant under this Act, securities broker, securities dealer, municipal securities broker, municipal securities dealer, transfer agent, clearing agency, securities information processor, investment adviser, investment company, or an affiliated person or employee of any of the foregoing; or (iii) involves embezzlement, theft, extortion, fraud, fraudulent conversion, misappropriation of funds, securities, or property, forgery, counterfeiting, false pretenses, bribery, or gambling; or (iv) involves the violation of section 152, 1341, 1342, or 1343 or chapter 25, 47, 95, or 96 of title 18, United States Code;

"(F) such person was debarred by any agency of the United States from contracting with the United States;

"(G) such person willfully made any material false or misleading statement or willfully omitted to state any material fact in his application or in any report required to be filed with the Commission by this Act or the regulations thereunder, or in any proceeding before the Commission;

"(H) such person has pleaded nolo contendere to criminal charges of felonious conduct, or has been convicted in a State court or in a foreign court of conduct which would constitute a felony under Federal law if the offense had been committed under Federal jurisdiction;

"(I) in the case of an applicant for registration in any capacity for which there are minimum financial requirements prescribed under this Act or under the rules or regulations of the Commission, such person has not established that he meets such minimum financial requirements;

"(J) such person is subject to an outstanding order denying, suspending, or expelling him from membership in a contract market, a registered futures association, or in any other self-regulatory organization, or barring or suspending him from being associated with any member or members of such contract market, association, or self-regulatory organization;

"(K) such person has been found by any court of competent jurisdiction or by any Federal or State agency or other governmental body, or by agreement of settlement to which any Federal or State agency or other governmental body is a party, (i) to have violated any statute or any rule, regulation, or order thereunder which involves embezzlement, theft, extortion, fraud, fraudulent conversion, misappropriation of funds, securities, or property, forgery, counterfeiting, false pretenses, bribery, or gambling, or (ii) to have willfully aided, abetted, counseled, commanded, induced, or procured such violation by any other person;

"(L) such person has associated with him any person and knows, or in the exercise of reasonable care should know, of facts regarding such other person that are set forth as statutory disqualifications in section 8a(2) of this Act;

"(M) there is other good cause; or

"(N) any principal, as defined in section 8a(2) of this Act, of such person has been or could be refused registration: *Provided,* That pending final determination under this subsection 8a(3), registration shall not be granted: *Provided further,* That such person may appeal from a decision to refuse registration or to condition registration made pursuant to the provisions of this subsection in the manner provided in paragraph (b) of section 6 of this Act; and";

(e) by amending subsection 8a(4), as so redesignated—

(1) by striking out the word "or," before the word "revoke" the first time it appears and inserting in lieu thereof a comma;

(2) by inserting the words ", or to place restrictions upon" after the word "revoke" the first time it appears;

(3) by striking out the words "subparagraph (2) (B) or (C)" and inserting in lieu thereof the words "section 8a(3)"; and

(4) by adding the following proviso at the end thereof: "; *Provided,* That such person may appeal from a decision to suspend, revoke, or to place restrictions upon registration made pursuant to the provisions of this subsection in the manner provided in paragraph (b) of section 6 of this Act; and";

(f) by amending subsection 8a(6)—

(1) by inserting the words "registered futures association, or self-regulatory organization as defined in section 3(a)(26) of the Securities Exchange Act of 1934," before the word "notwithstanding";

(2) by striking out the word "and" before the word "consumers"; and

(3) by inserting the following before the semicolon: "or investors or which is necessary or appropriate to effectuate the purposes of this Act: *Provided, however,* That any information furnished

by the Commission under this subsection shall not be disclosed by such contract market, registered futures association, or self-regulatory organization except in any self-regulatory action or proceeding";

(g) by striking out the period at the end of subsection 8a(9) and inserting in lieu thereof "; and"; and

(h) by adding a new subsection 8a(10) to read as follows:

"(10) to authorize any person to perform any portion of the registration functions under this Act, in accordance with rules approved by the Commission, and subject to the provisions of this Act applicable to registrations granted by the Commission.".

CERTAIN PROHIBITED TRANSACTIONS

SEC. 19. Section 9 of the Commodity Exchange Act (7 U.S.C. 13) is amended as follows:

(a) by amending subsection (a)—

(1) by striking out the words "futures commission merchant" and inserting in lieu thereof "person registered or required to be registered under this Act";

(2) by striking out the words "commission merchant" and inserting in lieu thereof "person or any employee or agent thereof";

(3) by striking out the words "of such futures commission merchant"; and

(4) by inserting the words "or which otherwise was received from any customer, client or pool participant in connection with the business of such person" after the word "contracts" the second time it appears;

(b) by amending subsection 9(d)—

(1) by inserting the following after "'decline guaranty',": "or any transaction for the delivery of any commodity under a standardized contract commonly known to the trade as a margin account, margin contract, leverage account, or leverage contract, or under any contract, account, arrangement, scheme, or device that the Commission determines serves the same function or functions as such a standardized contract, or is marketed or managed in substantially the same manner as such a standardized contract,";

(2) by inserting the following at the end of the first proviso after the words "at least three months": ", nor to any transaction entered into by the trustee of a trust established by such person over which such person exercises no control if such transaction is entered into solely to

hedge against adverse price changes in connection with such farming or ranching operations or is a transaction for the lease of oil or gas or other mineral rights or interests owned by such person"; and

(3) by adding a new proviso at the end thereof to read as follows: ": *And provided further*, That such prohibition against any investment transaction in an actual commodity shall not apply to a transaction in which such person buys or sells, directly or indirectly (except by means of an instrument regulated by the Commission), a United States Government security, a certificate of deposit or similar financial instrument if no nonpublic information is used by such person in such transaction"; and

(c) by inserting after the words " 'decline guaranty'," in each place they appear in subsection 9(e) the following: "or in any transaction for the delivery of any commodity under a standardized contract commonly known to the trade as a margin account, margin contract, leverage account, or leverage contract, or under any contract, account, arrangement, scheme, or device that the Commission determines serves the same function or functions as such a standardized contract, or is marketed or managed in substantially the same manner as such a standardized contract".

REAUTHORIZATION; OFF-EXCHANGE JURISDICTION

SEC. 20. Section 12 of the Commodity Exchange Act (7 U.S.C. 16) is amended—

(a) by amending subsection 12(d) to read as follows:

"(d) There are hereby authorized to be appropriated to carry out the provisions of this Act such sums as may be required for each of the fiscal years beginning October 1, 1982 and ending September 30, 19 ."; and

(b) by adding a new subsection 12(e) to read as follows:

"(e) Nothing in this Act shall supersede or preempt: (1) any Federal criminal statute; (2) any Federal or State statute, including any rule or regulation thereunder, that is applicable to any transaction in or involving any commodity, product, right, service, or interest which is not conducted on or subject to the rules of a contract market or subject to regulation by the Commission under Section 4c or 19 of this Act; or (3) the application of any Federal or State statute, including any rule or regulation thereunder, to any person required to be registered or designated under this Act who shall fail or refuse to obtain such registration or designation. The Commission is authorized to refer any transaction or matter subject to such other Federal or State statutes to any department or agency administering such statutes for such investigation, action or proceedings as the department or agency shall deem appropriate.

AIDING AND ABETTING

SEC. 21. Section 13 of the Commodity Exchange Act (7 U.S.C. 13c) is amended as follows:

(a) by striking out the words "in administrative proceedings under this Act" in subsection 13(a);

(b) by redesignating existing subsection (b) as subsection (c); and

(c) by adding a new subsection (b) to read as follows:

"(b) Any person who, directly or indirectly, controls any person who violates any provision of this Act or any of the rules, regulations, or orders issued pursuant thereto may be held responsible for such violation as a principal, unless the controlling person did not know or, in the exercise of reasonable care, did not have reason to know, of the facts constituting the violation.".

REPARATIONS PROCEDURE

SEC. 22. Section 14 of the Commodity Exchange Act (7 U.S.C. 18) is amended as follows:

(a) by striking out existing subsections (b), (c), and (e);

(b) by redesignating subsections (d) as (c); (f) as (d); (g) as (e); (h) as (f); and (i) as (g);

(c) by amending subsection (a)—

(1) by striking out the words "or required to be registered under section 4d, 4e, 4k, or 4m of" and inserting in lieu thereof the word "under" and by striking out everything after the words "to the Commission" before the period;

(2) by inserting at the end thereof the words "for an order awarding actual damages proximately caused by such violation";

(3) by adding a new subsection 14(b) to read as follows:

"(b) The Commission may promulgate such rules, regulations and orders as it deems necessary or appropriate for the efficient and expeditious administration of this section. Notwithstanding any other provision of law, such rules, regulations, and orders may prescribe without limitation, the form, filing and service of pleadings or orders; the nature and scope of discovery; counterclaims; motion practice (including the grounds for dismissal of any claim or counterclaim); hearings (including the waiver thereof, which may relate to the amount in controversy); rights of appeal, if any; and all other matters governing proceedings before the Commission under this section.";

(4) by changing the reference in subsection (d), as so redesignated, from "(g) to "(e)"; and

(5) by amending subsection (f) , as so redesignated, to read as follows:

"(f) Unless the party against whom a reparation order has been issued shows to the satisfaction of the Commission within fifteen days from the expiration of the period allowed for compliance with such order that either an appeal as herein authorized has been taken or payment of the full amount of the order (or any agreed settlement thereof) has been made, such party shall be prohibited automatically from trading on all contract markets and, if the party is registered with the Commission, such registration shall be suspended automatically at the expiration of such fifteen day period until such party shows to the satisfaction of the Commission that payment of such amount with interest thereon to date of payment has been made: *Provided,* That if on appeal the appellee prevails or if the appeal is dismissed the automatic prohibition against trading and suspension of registration shall become effective at the expiration of thirty days from the date of judgment on the appeal, but if the judgment is stayed by a court of competent jurisdiction the suspension shall become effective ten days after the expiration of such stay, unless prior thereto the judgment of the court has been satisfied.".

TECHNICAL AND CONFORMING AMENDMENTS

SEC. 23. Section 16 of the Commodity Exchange Act (7 U.S.C. 20) is amended by inserting the words "or market positions" after the word "transactions" in subsection (d).

SEC. 24. Section 17 of the Commodity Exchange Act (7 U.S.C. 21) is amended as follows:

(a) by amending paragraph (10) of subsection (b)—

(1) by striking out the words "a customer's" and inserting in lieu thereof "customers'";

(2) by striking out the comma before subparagraph (ii) and by striking out subparagraphs (ii) and (iii) in their entirety;

(3) by redesignating subparagraph (iv) as subparagraph (ii); and

(4) by striking out the words "a futures commission merchant or floor broker" and inserting in lieu thereof the words "another member of the association";

(b) by changing the reference in subsection (h) from subsection (k) to subsection (i);

(c) by striking out the last sentence in subsection (j) and by inserting in lieu thereof the following: "A registered futures association shall submit to the Commission any change in or addition to its rules and shall not place such rules into effect if, within ten days of receipt by the Commission of such submission, the registered futures association requests review and approval thereof by the Commission or the Commission notifies such registered futures association in writing of its determination to review for approval such rules. The Commission shall approve such rules, within thirty days of their receipt if Commission approval is requested hereunder or within thirty days after the Commission determines to review for approval any other rules, unless the Commission notifies the registered futures association of its inability to complete such approval or review within such period of time The Commission shall approve such rules if such rules are determined by the Commission to be consistent with the requirements of this section and not otherwise in violation of this Act or the regulations of the Commission and the Commission shall disapprove, after the appropriate notice and opportunity for hearing, any such rule which the Commission determines at any time to be inconsistent with the requirements of this section or in violation of the provisions of the Act or the regulations of the Commission."; and

(d) by adding a new subsection (o) to read as follows:

"(o) The Commission is authorized to require any futures association registered pursuant to this section to perform any portion of the registration functions under this Act with respect to each member of the association other than a contract market and with respect to each associated person of such member, in accordance with the rules approved by the Commission, and subject to the provisions of this Act applicable to registrations granted by the Commission.".

LEVERAGE TRANSACTIONS

SEC. 25. Section 19 of the Commodity Exchange Act (7 U.S.C. 23) is amended by adding a new subsection (e) to read as follows:

"(e) Notwithstanding the provisions of subsections (b), (c), or (d) of this section, no person shall offer to enter into, enter into, or confirm the execution of, any transaction subject to the provisions of subsection (b) of this section, who was not engaged in that business on June 1, 1978, and no person shall offer to enter into, enter into, or confirm the execution of, any transaction subject to the provisions of subsection (c) of this section, who was not engaged in that business on February 2, 1979: *Provided,* That such prohibitions shall terminate on September 30, 1984: *Provided further,* That within two years following the effective date of this subsection (e), the Commission shall conduct a study of such transactions and shall submit a report of the results of such study to the House Committee on Agriculture and the Senate Committee on Agriculture, Nutrition, and Forestry. Such report shall include the Commission's recommendations concerning whether the national public interest, if any, to be served by such transactions requires that they be federally regulated, whether the national public interest, if any, to be served by such transactions overrides any State interest in their regulation, whether such transactions should be prohibited, whether any such transaction is a contract for future delivery within the meaning of this Act, the appropriate regulatory scheme to govern any such transaction that the Commission determines is not a contract for future delivery within the meaning of this Act, and any proposals for additional legislation that the Commission believes should be enacted with respect to such transactions.".

USER FEES; TECHNICAL AMENDMENT

SEC. 26. (a) Section 26 of the Futures Trading Act of 1978 (7 U.S.C. 16a) is amended by striking out the existing language.

(b) The Commodity Exchange Act is amended by adding a new section 22 to read as follows:

"TRANSACTIOIN FEES

"SEC. 22. (a) Each contract market, or other board of trade licensed by the Commission shall remit to the Treasury of the United States, with written verification thereof to the

Commission, by March 15 of each year, a fee in the following amounts for each contract for the purchase or sale of a commodity for future delivery and for each commodity option subject to the provisions of section 4c of this Act entered on or subject to the rules of such contract market or board of trade during the preceding calendar year or portion thereof following the effective date of this section:

"(1) 12 cents for each such contract or option which is made or executed for the account or benefit of a person who is not a member of such contract market or board of trade or of a registered futures association; and

"(2) 6 cents for each such contract or option which is made or executed for the proprietary account (as defined by the Commission) of a person who is a member of such contract market, board of trade or of a registered futures association.

"(b) Each person who grants a commodity option pursuant to section 4c(d) of this Act, or who is engaged in the business of offering any leverage transaction pursuant to section 19 of this Act, shall remit to the Treasury of the United States, with written verification thereof to the Commission, by March 15 of each year, a fee of $3 for each such option granted or leverage contract entered during the preceding calendar year or portion thereof following the effective date of this section.

"(c) The fees assessed hereunder for any calendar year are intended not to exceed the funds appropriated by the Congress for the Commission's activities for the fiscal year in which remittance of the fees is due. In the event that the total fees remitted to the Treasury of the United States pursuant to this section for any calendar year or portion thereof exceed the funds appropriated for the Commission for the fiscal year in which remittance of the fees is due, the Commission shall, by rule, regulation, or order, suspend the assessment of fees in the current calendar year for such period as the Commission determines, to the extent practicable and based on current market volume, would otherwise generate an amount equal to excess fees remitted in the preceding calendar year. No fees shall be required to be remitted for transactions effected during such period of suspension determined by the Commission; provided that at the conclusion of such period, the obligation to assess fees to be remitted under this section shall resume.

"(d) Notwithstanding any other provision of this section, the Commission, after notice and opportunity for hearing, may by rule, regulation, or order reduce, suspend, or waive the application to any person or class of persons, of the fees or any portion thereof upon a finding that such action is necessary to prevent or correct any significant adverse effect upon any market or person occasioned by such fee.

"(e) The Commission shall create, prior to or after the effective date of this section, an advisory committee pursuant to the Federal Advisory Committee Act, comprised of persons materially affected by the operation of this section. Such advisory committee shall remain in existence until June 30, 1985. The advisory committee shall be empowered to advise the Commission with respect to the efficacy of the fee system created by this section, to consult with the Commission with respect to actions taken under subsection (d) hereof, to prepare a report containing its assessment and recommendations with respect to the fee system, and to perform such other duties and functions as the Commission may prescribe. Such report, together with the views and recommendations of the Commission, shall be submitted to the Committee on Agriculture of the House of Representatives and to the Committee on Agriculture, Nutrition, and Forestry of the United States Senate no later than June 30, 1985.".

○